Supreme Court, U.S.
FILED

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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1996

EDWARD A. SHAY, MARTIN L. LEHRER, RICHARD L. SMITH, ALLEN E. SHAY, and PACIFIC ARCHITECTS AND ENGINEERS, INCORPORATED,
Petitioners,

vs.

NEWMAN HOWARD, GILBERT LEON ALLEN, JOAN HOWARD and THEODORE H. POPE as representatives of plan participants similarly situated on behalf of THE EMPLOYEE STOCK OWNERSHIP PLAN OF PACIFIC ARCHITECTS AND ENGINEERS INCORPORATED,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

LARRY R. FELDMAN
Counsel of Record

LESTER G. OSTROV

FOGEL, FELDMAN, OSTROV, RINGLER & KLEVENS

1620 26th Street, Suite 100 South
Santa Monica, California 90404-4040
(310) 453-6711

Attorneys for Petitioners

Lawyers Brief Service • Appellate Brief Printers • (213) 613-1013 • (714) 720-1510

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QUESTIONS PRESENTED

1. Do ERISA plan fiduciaries who have retained a qualified independent valuation expert, and who have provided all relevant, material information and who have not provided any false or misleading information to that expert, breach their fiduciary duties by relying upon the expertise and opinions of the valuation expert?

2. Do ERISA fiduciaries breach their fiduciary duties by failing to question valuation principles developed under Revenue Ruling 59-60 which have been judicially approved and by relying on a fair market valuation which has utilized such valuation principles?

3. In an ERISA valuation of stock do the "fair market value" requirements mandated by ERISA pre-empt state law "liquidation value" methodologies contained in corporate involuntary dissolution statutes or must an ERISA fair market valuation take into consideration such state law liquidation values?

4. Can a court of appeals reverse a trial court's decision that ERISA fiduciaries did not breach their fiduciary duties with respect to the sale of stock without reversing the trial court's findings of fact that the fiduciaries properly selected a qualified, independent valuation expert, that the fiduciaries provided all relevant, material information and no false or misleading information to the expert, and that the sale price was for fair market value, and without concluding that any of the trial court's findings of fact was clearly erroneous?

PARTIES TO PROCEEDING
RULE 29.6 STATEMENT

All parties in this Court appear in the caption of the case.

Pursuant to Rule 29.6, the Court is advised that petitioner Pacific Architects and Engineers, Incorporated is a closely-held company with no parent company, and no publicly traded stock. Other than wholly-owned subsidiaries, petitioner's only subsidiaries are The 1216 Corporation, PAE (New Zealand) Limited, PAE Bumi Berlian SDN BHD, K.K. Halifax Associates, Nus Antara Pacific Limited, JINDO-PAE Limited, P.T. Paranada Ekayasa, Pacific Architects and Engineers Company Limited, PAE-Middle East, Pacific Services Company Limited, and Far East Equipment Leasing Limited. None of the petitioner's non wholly owned subsidiaries has issued stock to the public.

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PETITION FOR WRIT OF CERTIORARI

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit is reported at 100 F.3d 1484, and is reprinted as Appendix A.

The memorandum of decision, and the finding of facts and conclusions of law, of the United States District Court for the Central District of California (Tevrizian, D.J.) have not been reported. They are reprinted as Appendix E and D, respectively.

JURISDICTION

The opinion of the United States Court of Appeals for the Ninth Circuit, of which petitioners seek review, was entered on November 22, 1996. On February 13, 1997, the Court of Appeals denied a timely petition for rehearing and suggestion of appropriateness of rehearing *en banc*. (Appendix C). This petition is being timely filed within 90 days of that denial.

The jurisdiction of this Court to review the judgment of the Court of Appeals is invoked under 28 U.S.C. § 1254(1).

STATUTES INVOLVED

Sections 1002, 1104, 1106, 1108, and 1144 of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. §§ 1002, 1104, 1106, 1108, and 1144, are set forth in pertinent part in Appendix J. (App. at J1-J5). Additionally set forth in Appendix J are California Corporations Code § 1800, *et seq.* and 26 U.S.C. § 4975. (App. at J6-J9).

STATEMENT OF THE CASE

This case involves the interpretation and application of ERISA's provisions that require plan fiduciaries to obtain "adequate consideration" when selling assets of the plan, such as stock, to "parties in interest". 29 U.S.C. §§ 1106(1) and 1108(e). The plan at issue was created in 1972 by Pacific Architects and Engineers, Incorporated ("PAE") as an employee stock ownership plan ("ESOP"). (App. at A3). At all times relevant to this dispute, petitioners Richard L. Smith, Martin L. Lehrer, and Edward A. Shay were members of PAE's ESOP administrative committee (collectively "ESOP Committee"), as well as corporate officers of PAE, as is allowed by ERISA, 29 U.S.C. § 1008(c)(3). (App. at D2-D3).

The dispute in this case arises out of the ESOP Committee's decision in November of 1988 to sell the PAE stock held by the ESOP to a trust created by Edward A. Shay for $14.40 per share. Concurrent with the 1988 stock sale, PAE terminated the ESOP. (App. at A3). Prior to the 1988 stock sale, the ESOP Committee hired Arthur Young & Company ("Arthur Young") to perform a fair market valuation of the ESOP's stock holdings which consisted solely of the closely-held PAE shares. (App. at A3). Arthur Young utilized the accepted industry guidelines, set forth in Revenue Ruling 59-60, for valuation of closely-held corporate stock. (App. at E10). Arthur Young calculated PAE's asset value (without reference to any possible discounts) and then applied discounts for minority shareholder status and lack of liquidity and marketability. (App. at A5-A6). Arthur Young determined that the ESOP's shares had a fair market value of $14.40 per share. (App. at E10). Utilizing Arthur Young's valuation report, and a fairness opinion prepared by Arthur Young, the ESOP Committee, with Edward A. Shay abstaining, voted to sell the ESOP's 38.05% interest in PAE to a trust created by Edward A. Shay for the fair market value determined by Arthur Young - $14.40 per share. (App. at A3).

Plaintiffs Newman Howard, Joan Howard, Gilbert Leon Allen, and Theodore Pope (collectively "Howard")[1] filed this action claiming that the ESOP Committee members breached their fiduciary duties under ERISA. (App. at E3). The District Court's jurisdiction was proper under 28 U.S.C. § 1331. (App. at D7).

The ensuing six-week bench trial in the District Court (Tevrizian, D.J.) focused on the validity of Arthur Young's fair market valuation report and the propriety of the ESOP Committee's conduct with respect to the 1988 sale. The District Court found that the PAE ESOP committee did not breach their fiduciary duties under ERISA Section 404 or 406, 29 U.S.C. §§ 1106 and 1108(e), by relying on Arthur Young's expert valuation of the ESOP's stock holdings. (App. at D8-D10).

In reaching its decision, the District Court heard extensive testimony from each of the ESOP Committee members, Arthur Young's principal valuation experts, and retained valuation experts from each side. (App. E9-E12). Based on this testimony, and the documentary evidence presented, the District Court found:

- "Defendants provided all relevant, material information to Arthur Young & Company regarding the ESOP and PAE's assets and operations and did not provide any false or misleading information to Arthur Young & Company." (App. at D5).
- "The discounts or adjustments applied by Arthur Young & Company were appropriate, were not

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[1]On May 6, 1992 the District Court certified this action as a class action on behalf of "All persons who were participants in or beneficiaries of the Employee Stock Ownership Plan of Pacific Architects and Engineers Incorporated on November 8 and 9, 1988, at the time of its purported termination, except those participants who are named individual defendants in the instant action." (App. at D3).

improper or excessive, and were adequately justified by Arthur Young & Company and by the expert testimony offered by Defendants." (App. at D6).

- "The sale of the PAE stock by the PAE ESOP to the E. & A. Shay Irrevocable Trust was for fair market value determined in good faith." (App. at D7).
- "The per share price of $14.40 received for the PAE ESOP shares by the plan participants on November 9, 1988, was full, fair and adequate consideration." (App. at D7).
- "The sale of the PAE stock by the PAE ESOP to the E. & A. Shay Irrevocable Trust was for adequate consideration, as defined in 29 U.S.C. § 1002(18)(B)." (App. at D7).

The Court of Appeals (with O'Scannlain, J., dissenting) reversed, concluding that the ESOP Committee members failed to meet their burden of showing that the plan received "adequate consideration" and breached their fiduciary duties under ERISA. (App. at A11-A12). Without addressing the District Court's findings of fact, or any of the evidence presented at trial, the majority concluded that "even a cursory review of the Arthur Young valuation and fairness opinion reveals the carelessness of [the fiduciaries' reliance]." (App. at A9-A10). The majority criticized Arthur Young's valuation report, including Arthur Young allowing Edward A. Shay the full benefit of a minority discount, since Shay already owned the other sixty-percent of PAE's shares (App. at A10), and Arthur Young's purported failure to consider liquidation values under state-law valuation procedures contained in corporate involuntary dissolution statutes (which the majority also concluded were not pre-empted by ERISA's fair market value requirements). (App. at A10). The majority further concluded that an ERISA prudent fiduciary would have been knowledgeable enough with valuation techniques to have questioned the magnitude of the discounts employed by Arthur Young and the valuation principles employed by

Arthur Young which the majority deemed to be flawed. (App. A10-A11).

The dissenting opinion disagreed with the majority's reasoning and approach. The dissent found that the majority was creating a "new and unwarranted requirement," which could not be supported by prior law. (App. at A12-A13). The dissent found that the "majority's unprecedented rule essentially requires the fiduciaries to be experts in subjects in which they admittedly have insufficient knowledge or experience."[2] (App. at A13). The dissent found that, "[f]iduciaries use experts precisely because they are not qualified to do the appraisal themselves; once they have carefully selected and adequately informed the expert, they should be able to rely on the expert's conclusions." (App. at A13).

REASONS FOR GRANTING REVIEW

I. The Ninth Circuit's decision directly conflicts with prior decisions of the Fifth and Seventh Circuits which found that an ERISA fiduciary may rely on a properly retained and qualified valuation expert's advice when the fiduciary provides the expert with all necessary and relevant information.

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[2]The dissent also questioned the majority's disregard for the District Court's findings of fact. The dissent concluded that the "district court specifically found that the fiduciaries in this case used an appropriate selection process in choosing Arthur Young, and that they provided Arthur Young with all relevant, material information. Unless that finding is clearly erroneous, this court should hold that the fiduciaries acted prudently." (App. at A13). The majority's opinion did not find the District Court's findings of fact clearly erroneous, but nevertheless found that the ESOP fiduciaries had acted imprudently. (App. at A11).

The decision of the Ninth Circuit is in direct conflict with the Fifth Circuit's decision in *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984), and the Seventh Circuit's decision in *Eyler v. C.I.R.*, 88 F.3d 445 (7th Cir. 1996). The *Cunningham* and *Eyler* Courts both found that an ERISA fiduciary may rely on an expert's valuation opinion, as long as the fiduciary provides complete, up-to-date information to a qualified valuation expert. In contrast, the Ninth Circuit's decision concluded that (even if the expert is provided such information) an ERISA fiduciary may not rely on an independent valuator's expertise but must instead be sufficiently knowledgeable in valuation techniques to review and question the methodologies employed by the valuation expert and then, if there are any "uncertainties," [3] the fiduciary must retain a second valuation expert.[4] (App. at A11, A13).

As in the instant case, the Fifth Circuit in *Cunningham* addressed an ERISA fiduciary's duties with regard to fair market valuations of closely-held corporate stock held by an

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[3]The majority decision does not define "uncertainties," nor give any guidance to fiduciaries as to how to conform their behavior to its requirements. There is not a scintilla of evidence in the record to suggest that the fiduciaries in this case in fact had any "uncertainties" regarding Arthur Young's valuation. The only "uncertainties" are those of the majority - "uncertainties" not shared by the District Court (or apparently by the dissent).

[4]It is far from clear that even a second (or third) valuator's opinion will satisfy the majority's requirements. Since a fair market valuation of closely-held corporate stock is an inexact science which is inherently difficult and subjective, such valuations may defy the level of certitude that the majority's standard requires. *See* footnote 12, *infra*.

ESOP under ERISA Section 2(18)(B).[5] *Cunningham, supra*, 716 F.2d at 1465-1466; *see also* 29 U.S.C. § 1002(18)(B); (App. at A2-A3). However, in stark contrast to the requirements placed on fiduciaries by the Court of Appeals below, the Fifth Circuit found that:

> "To use an independent appraisal properly, ERISA fiduciaries need not become experts in the valuation of closely-held stock -- they are entitled to rely on the expertise of others. However as the source of information upon which the experts' opinions are based, the fiduciaries are responsible for ensuring that that information is complete and up-to-date." *Cunningham, supra*, 716 F.2d at 1474 (footnote omitted).[6]

Thus, under *Cunningham*, when conducting a fair market valuation the fiduciary's conduct is key; the fiduciary must

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[5]In *Cunningham*, as in the instant case, fiduciaries of an ERISA-qualified ESOP engaged in a transaction involving closely-held corporate stock held by the ESOP with a "party-in-interest" (i.e. a plan fiduciary) thereby implicating the prohibitions of ERISA Section 406. *Cunningham, supra*, 716 F.2d at 1459. Such a transaction may only be undertaken if the fiduciaries show that the plan obtained (or paid only) "adequate consideration" pursuant to Section 408(e). 29 U.S.C. §§ 1106 and 1108(e). ERISA defines "adequate consideration" with regard to assets for which there is no ready market, such as closely-held corporate stock, as "the fair market value of the asset as determined in good faith" by the plan fiduciaries. 29 U.S.C. § 1002(18)(B).

[6]The *Cunningham* Court concluded that the ERISA-fiduciaries could not rely on the valuation performed in that case because the valuation was based on information which the fiduciaries knew to be out-of-date. The valuation was performed twenty months prior and significant changes to the company's financial condition had occurred. *Cunningham, supra*, 716 F.2d at 1469-1470.

provide complete and up-to-date information to the valuation expert. *Id.*; *accord*, *Scardelletti v. Bobo*, 897 F.Supp. 913, 918 (D.Md. 1995). Further, the *Cunningham* Court held that an ERISA fiduciary will not be held to the same standard as an expert in valuations; ERISA fiduciaries need not become valuation experts. *Cunningham, supra,* 716 F.2d at 1467, 1474, footnote 26.

The Ninth Circuit's decision directly conflicts with the Fifth Circuit's *Cunningham* decision. In the instant case, the District Court expressly found that the PAE ESOP fiduciaries provided Arthur Young with all the relevant, material information required to properly conduct the valuation and did not provide any false or misleading information. (App. at D5). Consequently, under *Cunningham's* standard, PAE's ESOP fiduciaries should have been able to properly rely on Arthur Young's valuation.

Under the rubric of "uncertainties," -- which as noted above were perceived only by the majority, and not by the fiduciaries or the trier of fact -- the majority concluded that an ERISA fiduciary may not rely on an independent valuator's expertise and must instead evaluate and question the expert's assumptions, methodologies, and techniques, and, indeed, have a second firm review the valuation. (App. at A10-A11).

The *Cunningham* Court expressly rejected requiring ERISA fiduciaries to be experts in valuations. *Cunningham, supra,* 716 F.2d at 1474. While the majority opinion pays lip service to this principle, its application of its newly created standard belies this statement. (App. at A11). As the dissenting opinion found, "[t]he majority's unprecedented rule essentially requires the fiduciaries to be experts in subjects in which they admittedly have insufficient knowledge or experience. Fiduciaries use experts specifically because they are not qualified to do the appraisals themselves . . . ." (App. at A13).

In applying its standard, the majority opinion concluded that the PAE ESOP fiduciaries breached their

fiduciary duties under ERISA because they failed to question particular aspects of Arthur Young's valuation methodology and assumptions which gave rise to "uncertainties." (App. at A11). Specifically, the majority concluded that a prudent ERISA fiduciary would have questioned: the size of the discounts; the use of a hypothetical buyer; and the failure to incorporate state-law liquidation in an ERISA fair market valuation. (App. at A9-A11). The Ninth Circuit thus requires a fiduciary to possess a high level of expertise with respect to valuation of closely-held corporate stock just to determine that "uncertainties" (as perceived by the majority) exist and to then meaningfully question the methodologies and assumptions employed by the expert.[7]

Requiring ERISA fiduciaries to possess such a high level of expertise is not only contrary to ERISA's purpose, it is also in direct conflict with the Fifth Circuit's decision in *Cunningham*.[8] Indeed, this Court recently warned the courts

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[7]As will be discussed more fully in Section II, *infra*, the Ninth Circuit's conclusions as to the proper application of these valuation principles evidence the difficulty of their application, and the level of expertise required. The conclusions drawn by the majority are in direct conflict with the decisional law developed under accepted principles of valuation.

[8]The requirements placed on ERISA fiduciaries by the Ninth Circuit is also contradictory to the Eighth Circuit's reasoning in *Roth v. Sawyer-Cleator Lumber Co.*, 16 F.3d 915 (8th Cir. 1994). In *Roth*, the Eighth Circuit found that "[e]ven if a trustee failed to conduct an investigation before making a decision, he is insulated from liability if a hypothetical prudent fiduciary would have made the same decision anyway." *Id.* at 919. The Court of Appeals below concluded that the ESOP Committee's failure to question Arthur Young's valuation amounted to a breach of their fiduciary duties, without directly addressing the District Court's findings that the discounts applied by Arthur Young were appropriate and that $14.40 was fair market value.

of "[Congress'] desire not to create a system that is so complex that administrative costs, or litigation expenses, unduly discourage employers from offering welfare benefit plans in the first place." *Varity Corp. v. Howe*, ___ U.S. ___, 116 S.Ct. 1065, 1070, 134 L.Ed.2d 130 (1996). However, the Court of Appeals in this case failed to heed this Court's admonition. Instead, the Ninth Circuit's decision has imposed new requirements on fiduciaries which will result in the very type of system this Court warned against in *Varity, supra.*

The expanded level of expertise and responsibilities imposed on fiduciaries by the Ninth Circuit in this case also conflicts with *Eyler v. C.I.R.*, *supra*, 88 F.3d 445, in which the Seventh Circuit recently addressed a taxpayer's claim that he properly conducted a fair market valuation pursuant to ERISA Section 408(e).[9]

Following the Fifth Circuit's reasoning in *Cunningham*, *supra*, the Seventh Circuit in *Eyler* also found that the critical question for the court was whether the valuation in question was based on complete and up-to-date information. *Eyler*, *supra*, 88 F.3d at 455. Since the *Eyler* Court found that the company's economic conditions had dramatically changed since the valuation was performed, the valuation could not be relied upon by the taxpayer. *Id.*

The precarious position in which the Ninth Circuit's decision places ERISA fiduciaries is not confined to fair

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[9]The *Eyler* Court addressed ERISA's fair market value provisions in the context of 26 U.S.C. § 4975. This provision imposes tax penalties for transactions prohibited by Section 406 of ERISA. In order not to be subject to the one hundred percent tax under Section 4975(b), a taxpayer must show that Sections 408(e)'s or 408(b)'s "adequate consideration" requirements were satisfied. These sections of ERISA require that the ERISA qualified pension plan receive adequate consideration as defined by ERISA. Thus, the *Eyler* Court necessarily had to interpret ERISA's fair market value provision, 29 U.S.C. § 1002(18)(B).

market valuations pursuant to Section ERISA 408(e). An ERISA fiduciary may not avoid undertaking such valuations because fiduciaries must conduct an annual valuation to determine the value of the plan's assets. 29 U.S.C. § 1023(b)(3)(A). Moreover, in order to engage in many transactions common to ERISA-qualified plans, fiduciaries must determine the fair market value of the plan's assets. *See e.g.*, 29 U.S.C. §§ 1108(b)(5), 1108(b)(7), 1108(e), and 1114(c)(5).

Further, ERISA fiduciaries may not simply avoid utilizing experts' advice. When there is no ready market by which to determine the value of plan assets, an ERISA fiduciary must utilize the expertise of an independent valuation expert. 26 U.S.C. § 401(a)(28)(c). Also, an ERISA fiduciary has an affirmative duty to utilize experts whenever the fiduciary lacks the requisite knowledge, experience, or skill to effectively evaluate decisions regarding the plan. *Katsaros v. Cody*, 744 F.2d 270, 279 (2d Cir.), *cert. denied*, 469 U.S. 1072 (1984); *Donovan v. Bierwirth*, 680 F.2d 263, 272-3 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982); *Donovan v. Walton*, 609 F.Supp. 1221, 1240 (D.C. Fla. 1985), *aff'd.* sub. nom. *Brock v. Walton*, 794 F.2d 586 (11th Cir. 1986).

The conflict of the decisions of the Ninth Circuit in this case with the Fifth and Seventh Circuits place a fiduciary in a precarious position. Under the decisions of the Fifth and Seventh Circuits, a lay fiduciary need not become an expert but may rely on the expertise of a properly retained valuation expert when the fiduciary has provided that expert with all relevant, material up-to-date information. Under the Ninth Circuit's decision in the instant case, a fiduciary must possess a high level of expertise in valuation principles and techniques, in order to identify purported uncertainties and second guess the expert's opinions. (App. at A13). Very few ERISA fiduciaries possess this level of expertise. In short, under the Ninth Circuit's decision, unlike the Fifth and Seventh Circuits, lay fiduciaries will be required to become valuation experts.

(App. at A13).

Such a conflict creates a complex system which will result in such high administrative costs and litigation expenses, that employers will be discouraged from creating ERISA plans. Fiduciaries may be required to hire at least two valuators. Further, fiduciaries do not have proper guidance to conform their conduct to the Court of Appeals' new standard. This Court has recognized that this type of system was one that Congress originally sought to avoid -- not create -- by enacting ERISA. *Varity, supra*, 116 S.Ct. at 1070.

A review of the Court of Appeals' decision below is necessary to resolve the conflict among the circuits regarding the level of expertise that a fiduciary must possess under ERISA, and ERISA's requirements regarding the use of experts when undertaking to determine the value of assets. Additionally, given the broad range of ERISA provisions requiring fiduciaries to determine the fair market value of plan assets, the requirement that experts be used to value such assets, and the number of plans impacted by such valuations, as well as the frequency of such valuations, the issues raised by this case relating to the proper use of valuation experts by fiduciaries and the extent to which fiduciaries are entitled to rely on such experts, give rise to important questions of national importance concerning ERISA's requirements which have not been addressed by this Court and which should be settled by this Court.

II. The Ninth Circuit's decision erroneously challenges Arthur Young's application of the principles of valuation developed under Revenue Ruling 59-60, thereby creating a conflict with the Fifth and Seventh Circuits' application of these principles.

The majority of the Court of Appeals concluded that the ESOP Committee's reliance on Arthur Young's valuation

constituted a breach of their fiduciary duties because, "even a cursory review of the Arthur Young valuation and fairness opinion reveals the carelessness of this tact." (App. at A9-A10). The majority further concluded that since a prudent ERISA fiduciary would have questioned Arthur Young's purported errors and since the ESOP Committee did not, the fiduciaries breached their duties to the plan under ERISA. (App. at A10-A11). However, the Court of Appeals' analysis of Arthur Young's valuation and the purported flaws identified by the Court are directly contrary to the extensive body of regulatory and decisional law governing fair market valuations of closely-held corporate stock. The valuation principles criticized by the majority are well-settled principles of valuation developed under the "willing buyer and willing seller"[10] standard which have been consistently approved by the courts, the Internal Revenue Service, the Department of Labor, and industry practice and applied, under Revenue Ruling 59-60,[11] to closely-held corporate stock.[12]

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[10]The "willing buyer/willing seller" construct is derived from the Internal Revenue Service's regulations concerning fair market valuations set forth in Treasury Regulations §§ 20.2031-1(b)(estate tax) and 25.2512-1 (gift tax).

[11]The IRS has also set forth what has become the industry standard for valuations of closely-held corporate stock in Revenue Ruling 59-60, 1959-1 C.B. 237, which expressly incorporates the hypothetical "willing buyer/willing seller" formula. (App. at G2).

[12]The valuation of shares of a closely-held corporation has been recognized as an inexact science which is a very difficult undertaking and a task which is inherently subjective. *Righter* v. *United States*, 439 F.2d 1204, 1206-1207 (Ct. Cl. 1971); *Central Trust Co. v. United States*, 305 F.2d 393, 399 (Ct. Cl. 1962); *Bader v. United States*, 172 F.Supp. 833, 836 (S.D. Ill. 1959); *First Nat. Bank* of *Fort Smith* v. *United States*, 610 F.Supp. 933, 938 (D.C.

The Court of Appeals concluded that Arthur Young incorrectly "assumed that [Edward] Shay was entitled to the full benefit of [the minority discount] even though, once purchased, the ESOP's minority block would merge with his controlling block and he would capture all of the increased value." (App. at A10). This purported error in Arthur Young's methodology was so egregious that the ESOP Committee's failure to question it supported a finding that the fiduciaries had breached their duties under ERISA. (App. at A10). Yet, it is the Court of Appeals' own novel application of the "willing buyer/willing seller" standard that is in direct conflict with the well-settled principles governing fair market valuations.[13] In particular, the Court of Appeals' decision directly conflicts with the prior decisions of the Fifth Circuit in *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981), the Seventh Circuit in *Estate of Curry v. United States*, 706 F.2d 1424 (7th Cir. 1983), and the Ninth Circuit itself in *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982), which have all expressly refused to allow a valuator to consider the identity of a potential purchaser.

In *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981)(*en banc*), the Fifth Circuit expressly refused to allow a valuator to consider the identity of the buyer in

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Ark. 1985); *Estate of Gilford*, 88 T.C. 38 (1987) ("valuation issues are inherently imprecise and capable of resolution only by a Solomon-like pronouncement"). The Court of Appeals' erroneous application of valuation principles evidences the level of difficulty of properly applying them.

[13]The Court of Appeals disregarded the District Court's factual finding that the ESOP shares of PAE were purchased by the E. & A. Shay Irrevocable Trust (not Edward A. Shay). (App. at A10). The Irrevocable Trust was created by Edward A. Shay and his wife for the benefit of their children, and their children were the trustees of the trust. (App. at D4).

determining the value of the stock at issue. *Id.* at 1005-1006. In that case, Mrs. Bright and her husband owned fifty-five percent of the outstanding stock of several corporations. At her death, Mrs. Bright bequeathed 27.5% of the stock (her half of the community property) to a trust established for the benefit of her children, with her husband as the trustee. Under Texas law, Mr. Bright already owned the other 27.5% as his half of the community property division at his wife's death. *Id.* at 1000. The Internal Revenue Service ("IRS") argued that the stock should be valued as a fifty-five percent block (thereby requiring the incorporation of a control premium to increase its value) and then halve that amount to determine the 27.5% block's value. *Id.* The IRS argued that Mr. Bright would be able to capture the control premium value by selling the two 27.5% blocks as a unit, even though for tax purposes he was attempting to value the blocks separately. *Id.* at 1002. The *Bright* Court rejected the IRS's argument, finding that the "willing buyer/willing seller" standard required the use of an objective, hypothetical buyer and thus the identity of the buyer may not be taken into consideration when determining the stock's fair market value.[14] *Id.* at 1005.

The "willing buyer/willing seller" standard has been used as the standard by which valuations are conducted since the creation of the estate tax system. *United States v. Cartwright*, 411 U.S. 546, 551, 93 S.Ct. 1713, 1717, 36 L.Ed.2d 528 (1973). This principle has become the generally accepted standard for valuing assets which do not have a

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[14] Although in 1981, following the *Bright* decision, the IRS stated in Revenue Ruling 81-253, 1981-1 C.B. 187, that it would not follow the *Bright*, *supra*, decision, in 1993, following additional decisions by the courts consistent with *Bright*, the IRS ceased to contest the principles established in *Bright* (see Revenue Ruling 93-12, 1993-1 C.B. 202).

ready market.[15] This principle is defined as: "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reliable knowledge of relevant facts." *Id.* (quoting Treas.Reg. § 20.2031-1(b)) (Appendix H). The *Bright* Court found that:

> "[t]his cardinal rule for determining value has been universally applied, both by the Internal Revenue Service and the courts.
>
> "It is apparent from the language of [Reg. 20.2031-1(b)] that the 'willing seller' is not the estate itself, but is a hypothetical seller. In Revenue Ruling 59-60, the Internal Revenue Service has so held:
>
> > 'Court decisions frequently state in addition that the *hypothetical* buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.'
>
> 1959-1 C.B. at 237 (emphasis added). Courts also have so held. In *United States v.*

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[15]Revenue Ruling 59-60 is the recognized industry guideline for valuing closely-held corporate stock, whether it be in the context of trusts, (*InterFirst Bank Dallas, N.A. v. Risser*, 739 S.W.2d 882, 891 (C.A. Tex. 1987)), Internal Revenue Code 26 U.S.C. § 4975, (*Eyler, supra*, 88 F.3d at 451), or pursuant to ERISA's provisions, (*Foltz v. U.S. News & World Report, Inc.*, 865 F.2d 364, 369 (D.C. Cir.) *cert. denied*, 490 U.S. 1108 (1989) (incorporation of Rev. Rul. 59-60 by the ERISA plan)). Indeed, the Fifth Circuit expressly required the use of the willing buyer/willing seller principles under ERISA. *Sommers Drug Stores Co. v. Corrigan Enterprises, Inc.*, 793 F.2d 1456 (5th Cir. 1986), *cert. denied*, 479 U.S. 1034 (1987).

> *Simmons*, 346 F.2d 213, 217 (5th Cir. 1965), this court said that "the 'willing buyer and seller' are a hypothetical buyer and seller having a reasonable knowledge of relevant facts."

Estate of Bright, *supra*, 658 F.2d at 1005-1006 (emphasis in original)(footnote omitted).

Consequently, the *Bright* Court found that stock must be valued as two distinct blocks and a minority discount may be taken for the 27.5% block bequeathed by the wife, because the block did not consist of more than a fifty-percent interest in the subject corporations. *Bright*, *supra*, 658 F.2d at 1006-1007. Also, the *Bright* Court required that the block of stock to be valued was the stock actually transferred; its value after receipt was irrelevant. *Id.* at 1006.

The Ninth Circuit's decision in this case directly conflicts with the Fifth Circuit's decision in *Bright*, *supra*. Here, the Court found that the fiduciaries erred in relying on Arthur Young's valuation because the valuation did not consider the identity of the potential buyer, Edward A. Shay, when calculating the minority discount rate to be applied to the ESOP stock. (App. at A10). The *Bright* Court expressly rejected allowing a valuator to consider the seller's or buyer's identity. Under *Bright*, a valuator must use a ***hypothetical*** buyer and seller when determining fair market value. *Bright*, *supra*, 658 F.2d at 1005-6; Treas.Reg. 20.2031-1(b) (App. at H2). Further, under *Bright*, the asset to be valued in this case was the ESOP's stockholdings; not the combined holdings of Edward A. Shay and the ESOP. Thus, Edward A. Shay's identity as a potential purchaser, and any stock he owned were irrelevant to Arthur Young's valuation under the Fifth Circuit's decision in *Bright*.

The Seventh Circuit has also rejected the principles of valuation that the Court of Appeals' decision utilizes in this case. In *Estate of Curry v. United States*, 706 F.2d 1424, 1431 (7th Cir. 1983), the Seventh Circuit found that:

> "[Treas. Reg. §20.2031-1(b)] has been interpreted repeatedly by the Internal Revenue Service and the courts as requiring that the willing seller be posited as a 'hypothetical' seller and not a particular plaintiff seeking recovery. Revenue Ruling 59-60, 1959-1 C.B. 237; *Estate of Bright v. United States*, [*supra*, at 1006]; *United States v. Simmons*, [*supra*, at 217]; *Rothgery v. United States*, 475 F.2d 591, 594 (Ct.Cl. 1973)." *Curry, supra*, 706 F.2d at 1431.

Following the Fifth Circuit's decision in *Bright*, the *Curry* Court also found that the willing buyer/willing seller standard required the use of a hypothetical buyer and seller. *Id.* Thus, a valuator may not look to the identity of the purchaser of stock to determine the stock's fair market value. *Id.*

Furthermore, prior decisions of the Ninth Circuit have also expressly required the use of a hypothetical buyer and seller for fair market valuations. *See Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982).

The Ninth Circuit's decision in this case also conflicts with the Department of Labor's proposed regulations interpreting Section 2(18)(B)'s fair market value requirements. 29 U.S.C. § 1002(18)(B). The Department of Labor ("DOL") has expressly recognized the usefulness of the substantial authority developed in the tax law context for interpreting ERISA's fair market valuation requirements. (proposed 29 C.F.R. 2510-3.1(b) is reprinted at Appendix I.) Under the DOL's proposed 29 C.F.R. 2510-3.1(b), the DOL specifically incorporates the IRS's approach for valuations of closely-held corporate stock. In the introduction to the proposed rules, the DOL states:

> "The Internal Revenue Service has had occasion to address the valuation problems posed by one type of such securities -- securities issued by closely held corporations.

> Rev. Rul. 59-60, 1959-1 Cum. Bull. 237, lists a variety of factors to be considered when valuing securities of closely held corporations for tax purposes. The Department's experience indicates that Rev. Rul. 59-60 is familiar to plan fiduciaries, plan sponsors and the corporate community in general. The Department has, therefore, modeled this proposed special rule after Rev. Rul. 59-60 with certain additions and changes discussed below." (App. at I16-I17) (footnote omitted).

As the DOL's proposed regulation indicates, because the valuation principles developed under Rev. Rul. 59-60 are well-established and directly on point, this authority provides highly useful guidance to ERISA fiduciaries when performing fair market valuations pursuant to ERISA. *Sommers Drug Stores, supra,* 793 F.2d at 1462-1463.

Although the Court of Appeals does not directly address the District Court's finding that Arthur Young properly performed the fair market valuation consistent with Rev. Rul. 59-60, the majority concludes that the valuation was fatally flawed. (App. at A11). However, the critical flaw is in the Court of Appeals' decision that the identity of the buyer should have affected the fair market value -- a decision that conflicts with the decisions of the Fifth, Seventh, and Ninth Circuits decided under the principles set forth in Rev. Rul. 59-60.

Consequently, the Ninth Circuit's decision in this case places ERISA fiduciaries in an impossible position when conducting fair market valuations. If the hypothetical willing buyer/willing seller approach is not utilized, they will run afoul of Rev. Rul. 59-60, and the DOL's proposed regulations as well as the decisions of the Fifth, Seventh. If the hypothetical willing buyer/willing seller approach is utilized they will be in breach of their fiduciary duties under the instant decision.

III. The Ninth Circuit's decision that ERISA's fair market value requirements do not preempt liquidation valuation procedures contained in state corporate dissolution statutes and that an ERISA fair market valuation must take into account such state law liquidation values conflict with decisions of the Fifth and Eighth Circuits and of this Court.

Without addressing ERISA's preemption provisions, nor the decisional law of this Court interpreting these provisions, the Court of Appeals summarily dismissed ERISA's preemptive force, stating that:

> "we agree with plaintiffs that the district court erred in finding that ERISA preempts Cal. Corp. Code § 1800; 29 U.S.C. § 1144; *see Aloha Airlines, Inc. v. Ahue*, 12 F.3d 1498, 1504 (9th Cir. 1993). It seems, however, that even if ERISA did preempt Cal. Corp. Code § 1800, the statute would nevertheless deflate Pacific's minority interest discount, since a third-party buyer would be entitled to its possible benefit." (App. at A10).

The Court of Appeals further concluded that PAE's ESOP Committee had breached their fiduciary duties, in part, because Arthur Young had not incorporated the effects of liquidation value under Cal. Corp. Code § 1800 into its calculations of the fair market value of ESOP's stock. The Court of Appeals stated that, "Arthur Young applied a minority discount substantially higher than the recent historical average, but it did not consider whether protections offered by Cal. Corp. Code § 1800 would weigh against a higher discount . . . ." (App. at A6). The Court found that a "prudent fiduciary" would have questioned this approach. (App. at A10). The Ninth Circuit's conclusions are contrary

to decisions of this Court, and are in conflict with decisions of the Fifth and Eighth Circuits which found that valuations under ERISA must be conducted under ERISA's required fair market value standard, not liquidation value.

One of Congress' primary goals when enacting ERISA was to provide a national uniform standard for fiduciaries of pension plans. *Fort Halifax Packing Co. v. Coyne*, 482 U.S. 1, 11, 107 S.Ct. 2211, 2217, 96 L.Ed.2d 1 (1987). In *Fort Halifax*, this Court stated that:

> "ERISA's preemption provision was prompted by recognition that employers establishing and maintaining employee benefit plans are faced with the task of coordinating complex administrative activities. A patch-work scheme of regulation would introduce considerable inefficiencies in benefit program operation, which might lead those employers with existing plans to reduce benefits, and those without such plans to refrain from adopting them. Pre-emption ensures that the administrative practices of a benefit plan will be governed by only a single set of regulations." *Id.*

The Ninth Circuit's decision in this case will subject ERISA fiduciaries to a "patch work" of state laws when they calculate the fair market value of plan assets under ERISA; whether it be for qualifying for Section 408's "adequate consideration" standard, or for the annual valuation required pursuant to 29 U.S.C. §1023(b)(3)(A). Indeed, the Ninth Circuit's decision will result in fair market valuations being dependent on the state in which the corporation resides because in order to determine the value of a plan's assets, an ERISA fiduciary may not look solely to ERISA's requirement that valuations be determined on a fair market basis. Instead, a fiduciary must also look to the applicable state-law based valuation techniques, such as the liquidation value procedure

established for involuntary corporate dissolutions under Cal. Corp. Code § 1800, *et seq.*, in order to determine the value of an asset. Thus an ERISA-qualified plan in one state, that has exactly the same asset value under a fair market valuation as another plan in a different state, may have different asset values depending on the different state dissolution statutes which the Court of Appeals required the fiduciaries to incorporate. Such a result is in direct contravention of ERISA's goal of uniformity.

In particular, Cal. Corp. Code § 1800, *et seq.*, provides that a minority shareholder in a close corporation (less than 35 shareholders) may seek involuntary dissolution of the corporation and obtain a court ordered liquidation of its assets, if the shareholder shows that it is "reasonably necessary" to protect the shareholder's interest. Cal. Corp. Code § 1800(b)(5); (App. at J9). It is not disputed that participants of an ESOP have the same rights to invoke the involuntarily dissolution mechanism provided as any other shareholder would have under Cal. Corp. Code § 1800. However, no such proceeding is or was pending and there was no evidence in the record of any grounds for invoking such procedures.

The Court of Appeals in this case concluded that an ERISA fair market valuation must take into consideration liquidation value which may be provided for under certain circumstances under the state involuntary corporate dissolution statute. (App. at A10). The majority opinion concluded that ERISA's requirements that valuation be conducted under a fair market valuation approach did not preempt state laws which require liquidation value in cases of involuntary dissolution. Consequently, a fair market valuation conducted pursuant to ERISA must somehow incorporate liquidation value determined pursuant to state law.

The Ninth Circuit's decision is in conflict with decisions of the Fifth and Eighth Circuits and is contrary to recent decisions of this Court.

The Fifth Circuit addressed whether liquidation values may be incorporated into ERISA's fair market valuation requirements in *Sommers Drug Stores Co. v. Corrigan Enterprises, Inc.*, 739 F.2d 1456, 1461 (5th Cir. 1986), *cert. denied*, 479 U.S. 1034 (1987). In *Sommers*, the Fifth Circuit found that liquidation value and ERISA's fair market value requirements were distinct valuation techniques, and that ERISA required fair market value, not liquidation value. *Id.* at 1461. Consequently, in conflict with the Court of Appeals below, a valuation which incorporated liquidation value methodologies did not satisfy ERISA's requirements.[16] *Id.*

The Ninth Circuit's decision in the instant case also conflicts with the Eighth Circuit's decision in *McCallum v. Rosen's Diversified, Inc.*, 41 F.3d 1239 (8th Cir. 1994). In *McCallum*, the Eighth Circuit addressed a plan participant's argument that the value of individually-held corporate stock determined pursuant to a state court dissolution proceeding should be utilized to determine the value of stock held by an ESOP. In *McCallum*, a plan participant owned stock in a closely-held corporation individually and as a member of an ERISA-qualified plan. *Id.* at 1240. The plan participant attempted to utilize his rights under a state-law involuntary corporate dissolution statute in order to receive a court-ordered buyout of both the stock he individually-owned and that held in his account by the ESOP. *Id.*

Much like the plaintiffs in the instant case, the plan participant in *McCallum* argued that the value determined by the court pursuant to the state dissolution statute for the stock he owned individually must also be used to determine the

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[16]Indeed, the DOL's proposed regulations interpreting ERISA, 29 U.S.C. §1002(18)(B), also preclude the use of "distress value" in determining fair market value. *See* 53 Fed. Reg. 17632 (citing *Hooker Indus., Inc. v. Commissioners*, 3 E.B.C. 1849, 1854-55 (T.C., June 24, 1982)).

value of the stock held by the ESOP. However, the Eighth Circuit recognized that this Court has found that ERISA ". . . calls for federal supremacy when the [state and federal] regimes cannot be harmonized." *Id.* at 1241 (quoting *John Hancock Mut. Life Ins. Co. v. Harris Trust & Savings Bank*, 510 U.S. 86, 98, 114 S.Ct. 517, 525, 126 L.Ed.2d 524 (1993)). Consequently, the Eighth Circuit rejected,

> "the argument that a court valuation made for purposes of [the involuntary corporate dissolution statute] must also apply to any subsequent valuation of ESOP shares. Rather, the court-ordered valuation can be specifically limited to the [dissolution] claim and it need not have any effect whatsoever on any subsequent valuation made by the ESOP trustees." *McCallum, supra,* 41 F.3d 1241.

The Ninth Circuit's conclusions in this case mandate that PAE's ESOP shares be valued by taking into consideration the effect of California's state involuntary corporate dissolution provisions, in direct conflict with the Eighth Circuit's decision in *McCallum*.

This Court recently addressed the differences between "forced sales," as would be the case in a court ordered dissolution under Cal. Corp. Code § 1800, and "fair market value" in the bankruptcy context. *BFP* v. *Resolution Trust Corp.*, 511 U.S. 531, 114 S.Ct. 1757, 128 L.Ed.2d 556 (1994). There this Court noted:

> "That suspicion becomes a certitude when one considers that market value, as it is commonly understood, has no applicability in the forced-sale context; indeed, it is the very *antithesis* of forced-sale value. *Id.* at 537.

The Ninth Circuit's attempt to force fiduciaries to incorporate liquidation value into ERISA's fair market valuation requirements is contradictory to this Court's determination that the two values are distinct, mutually exclusive values.

Even though its is clear that ERISA's fair market valuation requirements may not be harmonized with Cal. Corp. Code § 1800's forced dissolution valuation methodology, the Court of Appeals summarily concludes that the ESOP Committee breached their fiduciary duties because Arthur Young did not incorporate into its fair market valuation the liquidation values of Cal. Corp. Code §1800.

The Ninth Circuit's decision will destroy ERISA's primary goal of establishing a uniform administrative system for pension plan fiduciaries. ERISA requires "fair market value", not liquidation value. The Ninth Circuit's decision thus is in conflict with the Fifth Circuit's decision in *Sommers Drug Store Co. v. Corrigan, supra;* the Eighth Circuit's decision in *McCallum, supra;* and this Court's decision in *Fort Halifax, supra,* and contradicts this Court's decision in *BFP v. Resolution Trust, supra.* Review by this Court is necessary in order to secure the uniform application of ERISA's fair market value requirements.

IV. The Ninth Circuit's decision conflicts with Fifth and Seventh Circuit decisions holding that valuation is a question of fact and with decisions of this Court and numerous courts of appeals establishing the "clearly erroneous" standard of review with respect to questions of fact.

After a six-week bench trial, the District Court in this action made express findings of fact. Specifically, the District Court found that the ESOP fiduciaries had properly engaged Arthur Young as an independent expert valuator and that the ESOP fiduciaries had provided Arthur Young "all relevant, material information" necessary for Arthur Young to perform the valuation and "did not provide any false or misleading information". (App. at D6-D7). Additionally, the District Court found that the discounts applied by Arthur Young were

"appropriate, were not improper or excessive, and were adequately justified by Arthur Young and Company and by the expert testimony offered by Defendants." (App. at D7). The testimony of plaintiffs' experts did not persuade the District Court because these witnesses "couldn't offer any objective persuasive evidence or reasons as to why the discounts should not be applied." (App. at E11). The District Court found that the $14.40 per share price (as properly determined by Arthur Young) was "full, fair and adequate consideration" for the ESOP's stock holdings. (App. at D7). Further, the District Court expressly found that the $14.40 per share price constituted the fair market value determined in good faith by the ESOP fiduciaries for the ESOP stock and was adequate consideration as defined by ERISA Sections 2(18)(B) and 408(e), 29 U.S.C. §§ 1002(18)(B) and 1108(e). (App. at D6-D7). Consequently, the District Court found that none of the ESOP Committee members had breached their fiduciary duties owed to the ESOP under ERISA. (App. at D9-D10).

The Court of Appeals did not find any of the District Court's findings of fact clearly erroneous. Moreover, the Court of Appeal did not address the evidence (whether documentary or testimonial) produced at trial on which the District Court expressly based its findings. As the dissenting opinion noted, "the district court specifically found that the fiduciary in this case used an appropriate selection process in choosing Arthur Young, and that they provided Arthur Young with all relevant, material information. Unless that finding is clearly erroneous, this Court should hold that the fiduciaries acted prudently." (App. at A13)

Nevertheless, the Court of Appeals simply refers to the District Court finding that the $14.40 per share price was "full, fair, and adequate consideration," and then concludes that PAE's ESOP fiduciaries failed to establish "that the ESOP received adequate consideration for its Pacific stock." (App. at A7, A11).

Under Federal Rule of Civil Procedure ("FRCP"), Rule

52(b), " [a] Court of Appeals is permitted to reject the District Court's findings only if those findings are clearly erroneous." *Citibank, NA. v. Wells Fargo Asia Ltd.*, 495 U.S. 660, 670, 110 S.Ct. 2034, 2040, 109 L.Ed.2d 677 (1990). FRCP 52(a) states that:

> "Findings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of the witnesses."

Here, not only does the Court of Appeals' decision fail to find the District Court's findings of fact clearly erroneous, the Court of Appeals does not address them directly and fails to address any of the evidence presented in a six-week bench trial.

Whether PAE's ESOP fiduciaries obtained fair market value in good faith for the ESOP's stock holdings is pivotal to a determination of this case. Although the Court of Appeals is not bound by a trial court's characterization of fact or law, almost every court that has addressed questions involving the fair market value of stock has come to the conclusion that the valuation of stock is a "question of fact", which must be reviewed under the clearly erroneous standard. *E.g., Eyler v. Commissioner, supra*, 88 F.3d 445, 452 (involving valuation of ERISA ESOP shares); *Estate of Bonner v. United States*, 84 F.3d 196, 198 (5th Cir. 1996); *Ahmanson Foundation v. United States*, 674 F.2d 761, 769 (9th Cir. 1981); *Estate of O'Connell*, 640 F.2d 249, 251-252 (9th Cir. 1981).

The Court of Appeals in this case ignored the District Court's finding, based on the extensive testimony and documentary evidence presented at the six-week bench trial, that the discounts "were not improper or excessive." Unlike the Court of Appeals, the District Court had ample opportunity to view the evidence, evaluate the witnesses' credibility, and ask questions of those witnesses. Also, unlike the Court of Appeals, after the six week bench trial the

District Court did not have "uncertainties" concerning Arthur Young's valuation. The District Court stated:

> "Arthur Young & Company's stated rationale for the application of all of these discounts was that they were appropriate and were necessary to induce an outside third party purchaser (under the willing buyer-willing seller test of Revenue Ruling 59-60) to consider buying the approximately 38.05% minority interest in PAE owned by ESOP. In the body of the valuation report (Exhibit 2548), Arthur Young & Company specifically details and articulates its reasoning and rationale behind each of the discounts taken. At trial, defendants' witnesses, both percipient and expert, clearly articulated the propriety and reasoning for each of the discounts taken. Plaintiffs' experts on the other hand were not able to articulate any logical or legal reason for disallowing the discounts taken by Arthur Young & Company. Plaintiffs' experts for the most part disagreed with the discounts taken but couldn't offer any objective persuasive evidence or reasons as to why the discounts should not be applied."
> (App. at E10-E11).

Instead of addressing the District Court's findings of fact and the evidence supporting them, the Court of Appeals simply made statements such as: "Arthur Young did not explain why it settled on 50%, as opposed to a percentage closer to the average [discount rate] . . . " or "[Arthur Young] did not explain why the factors it cited warranted jacking up [the minority discount] . . . ." (App. at A6, A7). The Court of Appeals failed to address the District Court's contrary finding that Arthur Young did explain the valuation.

The Court of Appeals is not allowed to retry the facts

of a case. FRCP 52(b).[17] Rather, it is bound by the factual findings of the District Court, unless it finds those findings clearly erroneous. *Id.* The Court of Appeals' complete disregard for the District Court's findings of fact undermines the procedures of appellate review required by FRCP 52(b). It in effect advocates removing certain cases, such as those which concern fair market valuations under ERISA, out of the procedures mandated by FRCP 52(a) and allowing a Court of Appeals to retry the facts of a case. Not only does the Ninth Circuit's decision in this case violate the express language of Rule 52(b), the Court's decision is also in conflict with the Seventh Circuit decision in *Eyler, supra,* and the Fifth Circuit decision in *Estate of Bonner, supra*, and this Court's decision in *Citibank, N.A., supra.* These courts have refused to simply avoid the district court's findings of fact with regard to a fair market valuation under ERISA. Instead, these courts -- properly applying Rule 52(b) -- reviewed the district court's findings on a clearly erroneous standard. For this reason, petitioner, respectfully requests this Court grant certiorari to resolve this conflict and reaffirm the application of FRCP 52(b) in ERISA valuation contexts.

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[17]FRCP 52(b)'s limitations are especially pertinent to questions of value. "Justice Learned Hand observed that the powers of review of a court of appeals 'are very strictly limited upon issues of fact . . . and that limitation is particularly narrow when the issue is one of value.'" *Estate of Goodall v. C.I.R.*, 391 F.2d 775, 786 (8th Cir. 1968)(quoting *Sisto Financial Corp. v. C.I.R.*, 149 F.2d 268, 269 (2d Cir. 1945)).

CONCLUSION

For all of the foregoing reasons, the petition should be granted.

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Respectfully Submitted,
LARRY R. FELDMAN
Counsel of Record

LESTER G. OSTROV

FOGEL, FELDMAN, OSTROV,
RINGLER & KLEVENS

Attorneys for Petitioners
Edward A. Shay, Martin L.
Lehrer, Richard L. Smith,
Allen E. Shay, and Pacific
Architects and Engineers,
Incorporated

APPENDIX A

FOR PUBLICATION

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

NEWMAN HOWARD; GILBERT LEON ALLEN; JOAN HOWARD; THEODORE H. POPE, as Representatives of Plan Participants Similarly Situated on Behalf of THE EMPLOYEE STOCK OWNERSHIP PLAN OF PACIFIC ARCHITECTS AND ENGINEERS INCORPORATED,

Plaintiffs-Appellants,

v.

EDWARD A. SHAY; MARTIN L. LEHRER; RICHARD L. SMITH; ALLEN SHAY; PACIFIC ARCHITECTS AND ENGINEERS, INC.,

Defendants-Appellees.

No. 93-56605

D.C. No. CV-91-00146-DT

OPINION

Appeal from the United States District Court
for the Central District of California
Dickran M. Tevrizian, District Judge, Presiding

Argued and Submitted
July 10, 1995—Pasadena, California

Filed November 22, 1996

Before: Jerome Farris, Diarmuid F. O'Scannlain, and A. Wallace Tashima,* Circuit Judges.

*At the time of oral argument, Judge Tashima was a United States District Judge for the Central District of California, sitting by designation.

Opinion by Judge Farris;
Dissent by Judge O'Scannlain

COUNSEL

Raymond G. Kolts, Gary C. Nawa, Kolts & Nawa, Pasadena, California, for the plaintiffs-appellants.

Lester G. Ostrov, Fogel, Feldman, Ostrov, Ringler & Klevens, Santa Monica, California, for the defendants-appellees.

Wayne R. Berry, United States Department of Labor, Plan Benefits Security Division, Washington, D.C., for the amicus curiae.

OPINION

FARRIS, Circuit Judge:

INTRODUCTION

The plaintiffs are participants in an Employee Stock Ownership Plan that was created for the benefit of the employees of Pacific Architects and Engineers, Inc., a California corpo-

ration. In 1974, the ESOP purchased approximately 40% of Pacific's stock from Edward Shay for $4,269,162, or $10.67 per share. Shay was the president and chairman of Pacific, he was one of the ESOP's fiduciaries, and, prior to the sale, he owned 100% of Pacific's stock. In 1988, Shay's co-fiduciaries, Richard Smith and Martin Lehrer, both of whom worked for Shay as senior executives, caused the ESOP to sell its Pacific stock back to Shay for $14.40 per share, a price determined by Arthur Young, Inc., the ESOP's valuator. On its purchase and sale of the Pacific stock, the ESOP earned a compound annual return of 2.2%, a meagre gain considering that while the ESOP held the Pacific stock, the company was a substantial beneficiary of what Arthur Young called a "parabolic" rise in Japanese real estate values. The ESOP participants sued Shay, Lehrer, and Smith under ERISA for breach of their fiduciary duties. The district court held a bench trial and concluded that there was no breach and that the ESOP received adequate consideration for its stock. We reverse and remand for a determination of damages.

BACKGROUND

I. *The Transaction*

Pacific was primarily a real estate holding company, although it also had engineering and architecture operations. It owned both foreign and domestic real estate, and held a 50% interest in a Japanese real estate corporation called K.K. Halifax. Pacific created the ESOP in 1972 as an "employee pension benefit plan" as defined by ERISA. 29 U.S.C. § 1002(2)(A)(ii). Prior to the 1988 transaction, Shay, Smith, and Lehrer were the three fiduciaries of the ESOP and were members of its advisory committee.

In 1987, Smith contemplated the possibility of terminating the ESOP and consulted with Private Capital Corp., a financial advisor. Private Capital told Smith that there were problems with the valuation methodology used by Pacific's

valuator, Emco Financial Ltd., and recommended that Pacific replace Emco with a valuator capable of valuing Japanese real estate. Following Private Capital's advice, Smith began a search for a new valuator. After speaking with a number of firms and discussing with them the applicability of liquidity and minority interest discounts, Smith selected Arthur Young. As a condition of its retention, Arthur Young agreed not to contact Jardine Mathison, who owned the other 50% of K.K. Halifax. In May 1988, Arthur Young performed its first valuation and concluded that the ESOP's stock was worth $14.40 per share.

By July 1988, Pacific executives had informed Arthur Young that Shay was interested in purchasing the ESOP's stock and in September the ESOP administrative committee formally retained Arthur Young to perform a valuation to assist them in considering a possible offer. On November 8, 1988, Arthur Young issued a valuation report and fairness opinion representing that the ESOP's stock was worth $14.40 per share. That day, Pacific's board, which included Shay, Lehrer, and Smith, voted to terminate the ESOP. And by the next day, the ESOP administrative committee had voted to sell all of the ESOP's Pacific stock to the E. & A. Shay Irrevocable Trust. Shay abstained from both votes. Lehrer admits, however, that the ESOP administrative committee had agreed in advance that the Arthur Young valuation would set the transaction price, even though the fiduciaries had not yet seen the Arthur Young valuation.

II. *The Arthur Young Valuation*

Because the fiduciaries relied on Arthur Young's valuation without further investigation, it is necessary to consider Arthur Young's methodology. To help Arthur Young value Pacific, the fiduciaries provided it with historical financial statements and independent real estate appraisals. Arthur Young stated that it relied completely on this information: "We have relied upon the assertion of management and other

third parties that the financial data and real estate appraisal reports described in this report provide a reasonable representation of the fair market value and historical operation of the company and the condition of [Pacific's] real estate investments." Also, Arthur Young relied on Pacific attorney Carol May's assertion that Cal. Corp. Code § 1800, the statute that protects minority interest shareholders, did not give the ESOP the right to trigger an involuntary dissolution: "Our opinion is based upon the representation by both [Pacific's] management and the ESOP's administrator that they have reviewed the provisions of Section 1800(b)(1)-(6) of the California Corporations Code (Code) and that there were no facts existing that would provide grounds for the involuntary dissolution of [Pacific]."

Arthur Young defined the fair market value of the ESOP block as "the price at which the property would exchange between a willing buyer and a willing seller, neither being under compulsion to buy or sell, each having reasonable knowledge of all relevant facts, and with equity to both." Based on the information provided, Arthur Young separated Pacific's three asset components and assigned values to each. These included (1) Pacific's 50% interest in K.K. Halifax, a venture that held Japanese real estate, (2) Pacific's interests in other real estate, and (3) Pacific's operations. The Japanese real estate had been appraised at $120,178,000 million, making the net asset value of Pacific's 50% interest worth $59,997,000, after minor adjustments. The other real estate had been appraised at $18,178,000. And Arthur Young estimated the value of Pacific's operations to be $5,250,000.

To derive a value for the ESOP's stock, Arthur Young applied a series of discounts. First, Arthur Young applied a 60% discount to Pacific's interest in K.K. Halifax. Next, because the ESOP owned only 40% of Pacific and could not control the company, Arthur Young applied a minority interest discount of 40 to 50%. And finally, because there was no ready market in Pacific stock, Arthur Young applied a liquid-

ity discount of 50%. By applying these discounts, Arthur Young calculated that although Pacific had a net asset value over $83 million, for a per share net asset value of over $83, the fair market value of the ESOP's stock was $14.40 per share.

Arthur Young's primary input in valuing Pacific was selecting the three discount factors. We review briefly its justifications for each. First, with respect to the 60% discount applied to Pacific's 50% interest in K.K. Halifax, Arthur Young's valuation report explained that Pacific did not have controlling interest, that the other 50% owner was more powerful than Pacific, and that Japanese real estate was overvalued and volatile. But Arthur Young presented no studies of Japanese minority interest or liquidity discounts, nor did it present any analysis of Japanese ventures with comparable discount factors. In its May valuation, Arthur Young had actually applied a 40% discount, but in its November valuation, it gave no explanation why it increased the discount by twenty percentage points.

Second, with respect to the 40 to 50% minority interest discount, Arthur Young explained that it was typical for investors in late 1987 to pay 40% premium for control, and that this would correlate to a 28.6% discount factor. Although an outside study cited by Arthur Young indicated that this was consistent with historical discounts, Arthur Young concluded that 28.6% was too low for Pacific and multiplied this number by 1.5 to reflect a variety of factors including "concern[s] about future potential declines in Japan's real estate prices," Japan's higher tax rate, and "the volatility of the dollar/yen exchange rate." Arthur Young did not consider whether Cal. Corp. Code § 1800 would have a countervailing affect; it did not explain why the factors it cited warranted jacking up the average minority interest discount by 150%, as opposed to some lesser percent; and it did not compare Pacific with companies that had minority interest discounts that deviated 150% from the average.

Third, with respect to the liquidity discount, Arthur Young cited four studies "which indicated an average or median marketability discount of approximately 30 to 35 percent." Arthur Young concluded, however, that this amount was too low and that 50% was a more appropriate liquidity discount. Its reasons for deviating from the average included the fact that Pacific had "the right of first refusal for any ESOP stock," Pacific had litigation exposure, and the Japanese real estate market was overvalued and volatile. Arthur Young did not explain why it settled on 50%, as opposed to a percent closer to the average, and it did not compare Pacific with other companies that had 50% liquidity discounts.

III. *The District Court Opinion*

After a six week bench trial, the district court ruled in favor of the ESOP fiduciaries. The district court found that Arthur Young had received from the fiduciaries "all relevant, material information," and that Cal. Corp. Code § 1800 was preempted by ERISA. The district court remarked that "utilizing the business judgment rule this Court cannot find that the [Pacific] ESOP committee breached any fiduciary duty in relying on the Arthur Young & Company independent valuation and fairness opinion . . . ." It concluded that the fiduciaries had acted with the "care, skill . . . and diligence of a prudent fiduciary" and that $14.40 per share was "full, fair, and adequate consideration."

DISCUSSION

[1] "ERISA is a comprehensive statute designed to promote the interests of employees and their beneficiaries in employee benefit plans." *Shaw v. Delta Air Lines, Inc.*, 463 U.S. 85, 90 (1983). An ERISA fiduciary must act for the exclusive benefit of plan beneficiaries, 29 U.S.C. § 1104(a)(1), and must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would use in the con-

duct of an enterprise of a like character and with like aims." 29 U.S.C. § 1104(a)(1)((B). These duties are the "highest known to the law." *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982). To enforce them, the court focuses not only on the merits of the transaction, but also on the thoroughness of the investigation into the merits of the transaction. *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983); *Donovan v. Mazzola*, 716 F.2d 1226, 1233 (9th Cir. 1983) (question is whether fiduciary "employed the appropriate methods to investigate the merits of the investment and to structure the investment").

[2] In addition to imposing duties of loyalty and care, ERISA explicitly prohibits a fiduciary from engaging in self-dealing transactions: "A fiduciary with respect to a plan shall not . . . (2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries." 29 U.S.C. § 1106(b). ERISA creates an exception to this prohibition, however, by permitting "the acquisition or sale by a plan of qualifying employer securities . . . (1) if such acquisition [or] sale . . . is for adequate consideration." 29 U.S.C. § 1108(e). Like the inquiry into whether a fiduciary acted with loyalty and care, the inquiry into whether the ESOP received adequate consideration focuses on the thoroughness of the fiduciary's investigation. *Cunningham*, 716 F.2d at 1467-68.

[3] A fiduciary who engages in a self-dealing transaction pursuant to 29 U.S.C. § 1108(e) has the burden of proving that he fulfilled his duties of care and loyalty and that the ESOP received adequate consideration. *Id.* at 1467-68; *see also Marshall v. Snyder*, 572 F.2d 894, 900 (2d Cir. 1978). This burden is a heavy one. When it is "possible to question the fiduciaries' loyalty, they are obliged at a minimum to engage in an intensive and scrupulous independent investigation of their options to insure that they act in the best interests

of the plan beneficiaries." *Leigh v. Engle*, 727 F.2d 113, 125-26 (7th Cir. 1984).

[4] Although securing an independent assessment from a financial advisor or legal counsel is evidence of a thorough investigation, *Martin v. Feilen*, 965 F.2d 660, 670-71 (8th Cir. 1992), it is not a complete defense to a charge of imprudence. *See Mazzola*, 716 F.2d at 1234. As Judge Friendly has explained, independent expert advice is not a "whitewash." *Donovan v. Bierwirth*, 680 F.2d 263, 272 (2d Cir. 1982); *Donovan v. Walton*, 609 F. Supp. 1221, 1227 n.10 (D.C. Fla. 1985); *Cator v. Herrgott & Wilson, Inc.*, 609 F. Supp. 12, 16 (D.C. Cal. 1984). The fiduciary must (1) investigate the expert's qualifications, *Mazzola*, 716 F.2d at 1234, (2) provide the expert with complete and accurate information, *Cunningham*, 716 F.2d at 1467, and (3) make certain that reliance on the expert's advice is reasonably justified under the circumstances. *Id.* at 1474; *see also* Jordan, Pflepsen, Jr., & Goldberg, *ERISA Litigation Handbook*, § 3.03[A] (1994).

The plaintiffs have argued that the district court erred in applying the business judgment rule, rather than the prudent man standard. We agree that the district court exhibited some confusion over the correct articulation of the prudent man standard. The business judgment rule is a creature of corporate, not trust, law. But we reverse on the grounds that even if the district court applied the prudent man standard, it did not apply it correctly. The fiduciaries failed to carry their burden of proving that they fulfilled their duties of care and loyalty and that the ESOP received adequate consideration.

[5] The focus is on the thoroughness of the investigation. The fiduciaries completed the transaction without negotiation. Rather than shop the stock to a third-party buyer or appoint a non-conflicted fiduciary, the fiduciaries relied on the Arthur Young valuation, but they did not question the valuation or retain a second firm to review it. Even a cursory review of the Arthur Young valuation and fairness opinion reveals the care-

lessness of this tack. First, Arthur Young discounted the value of Pacific's ownership of K.K. Halifax by 60%, thereby erasing more than $35 million of value (before the application of liquidity and minority interest discounts), without providing any empirical support for a 60% discount or giving any explanation as to why it increased this discount factor twenty percentage points since its May valuation. A prudent fiduciary would have sought an explanation.

[6] Second, Arthur Young applied a minority interest discount substantially higher than the recent historical average, but it did not consider whether protections offered by Cal. Corp. Code § 1800 would weigh against a higher discount,* and it assumed that Shay was entitled to the full benefit of this discount even though, once purchased, the ESOP's minority block would merge with his controlling block and he would capture all of the increased value. A prudent fiduciary would have questioned these assumptions.

[7] And finally, Arthur Young applied a liquidity discount more than fifteen percentage points above the historical average. Although it gave reasons for deviating from the average, Arthur Young did not explain why these reasons resulted in an increase of fifteen percentage points as opposed to some lesser amount. Moreover, Arthur Young explained that the reason for the high liquidity discount factor was the overvaluation and volatility of Japanese real estate, even though it had already cited this as a reason for increasing the K.K. Halifax and minority interest discounts. Again, a prudent fiduciary would have questioned the fifteen percentage point adjustment and might have probed whether triple counting the

*We agree with plaintiffs that the district court erred in finding that ERISA preempts Cal. Corp. Code § 1800. 29 U.S.C. § 1144; *see Aloha Airlines, Inc. v. Ahue*, 12 F.3d 1498, 1504 (9th Cir. 1993). It seems, however, that even if ERISA did preempt Cal. Corp. Code § 1800, the statute would nevertheless deflate Pacific's minority interest discount, since a third-party buyer would be entitled to its possible benefit.

overvaluation and volatility of Japanese real estate was appropriate.

[8] An independent appraisal "is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled. It is a tool and, like all tools, is useful only if used properly." *Cunningham*, 716 F.2d at 1474. To justifiably rely on an independent appraisal, a conflicted fiduciary need not become an expert in the valuation of closely held corporations. But the fiduciary is required to make an honest, objective effort to read the valuation, understand it, and question the methods and assumptions that do not make sense. If after a careful review of the valuation and a discussion with the expert, there are still uncertainties, the fiduciary should have a second firm review the valuation.

Adopting the alternative rule — that an independent appraisal is a complete defense to a charge of imprudence — would be foolish, especially in cases in which there is a strong possibility of self-dealing. No court has adopted this rule, and the reason is fairly obvious. A fiduciary determined to self-deal has ample opportunity to sway the final valuation that will set the transaction price. The fiduciary can do so either in selecting of the expert or by limiting the information conveyed to the expert. This case illustrates the danger. Not only did Smith discuss liquidity and minority interest discounts with prospective valuators, but also, at least one firm, Ernst & Whinney, balked at his conditions of retention.

[9] Conflicted fiduciaries do not fulfill ERISA's investigative requirements by merely hiring an expert. Shay, Smith, and Lehrer did nothing else. A day after they got Arthur Young's valuation, they completed the transaction. They did not meaningfully review, discuss, or question the valuation. We cannot affirm the district court's holding that the fiduciaries carried their burden of proving that they fulfilled their

ERISA duties and that the ESOP received adequate consideration for its Pacific stock.

REVERSED and REMANDED.

O'SCANNLAIN, Circuit Judge, dissenting:

I agree with the majority that ERISA fiduciaries are held to the standard not of a "prudent lay person" but rather of a "prudent fiduciary with experience dealing with a similar enterprise." *Whitfield v. Cohen*, 682 F. Supp. 188, 194 (S.D.N.Y. 1988). If they do not have all of the knowledge and expertise necessary to make a prudent decision, they have a duty to obtain independent advice. Of course, the mere seeking of an independent appraisal does not, by itself, satisfy the prudence requirement. As the Fifth Circuit noted in an oft-quoted passage, "[a]n independent appraisal is not a magic wand that fiduciaries may simply waive over a transaction to ensure that their responsibilities are fulfilled. It is a tool, and, like all tools, is useful only if used properly." *Donovan v. Cunningham*, 716 F.2d 1455, 1474 (5th Cir. 1983).

Nevertheless, I know of no case in which ERISA fiduciaries were adjudged to have breached their duty when they carefully selected and accurately informed the independent appraiser of the relevant data. In fact, the Fifth Circuit has held that

> [t]o use an independent appraisal properly, ERISA fiduciaries need not become experts in the valuation of closely-held stock—they are entitled to rely on the expertise of others. However, as the source of the information upon which the experts' opinions are based, the fiduciaries are responsible for ensuring that that information is complete and up-to-date.

Cunningham, 716 F.2d at 1474 (citation omitted).

The majority cites this Fifth Circuit case to support the creation of a new and unwarranted requirement for ERISA fiduciaries who would obtain expert opinions—that fiduciaries must make certain that reliance on an expert's advice is reasonably justified under the circumstances. *Cunningham* simply does not stand for this proposition. The fiduciaries in that case had relied on an expert's valuation of the stock made *13 and 20 months before* the ESOP transactions. By the time of the ESOP transactions, the fiduciaries knew that the growth projections used by the expert were incorrect—the company had not actually done as well as projected. The fiduciaries nonetheless used the expert's valuation opinion to set the price of the stock for the ESOP transaction. The Fifth Circuit held that the fiduciaries had breached their duties—that they must provide complete and up-to-date information to experts before relying on the experts' opinion.

The crucial distinction between *Cunningham* and the case before us is that the *Cunningham* fiduciaries—the company's board of directors—knew that the company had not performed as well as the growth projections. In effect, they knew that the expert's appraisal was out of date. In this case, however, the majority faults the fiduciaries not for providing inaccurate data to the expert, but for failing to question the expert's methodology and valuation assumptions.

The district court specifically found that the fiduciaries in this case used an appropriate selection process in choosing Arthur Young, and that they provided Arthur Young with all relevant, material information. Unless that finding is clearly erroneous, this court should hold that the fiduciaries acted prudently. The majority's unprecedented rule essentially requires the fiduciaries to be experts in subjects in which they admittedly have insufficient knowledge or experience. Fiduciaries use experts precisely because they are not qualified to do the appraisal themselves; once they have carefully selected and adequately informed the expert, they should be able to rely on the expert's conclusions.

The district court also found that Arthur Young's valuation was appropriate, and that the price Arthur Young recommended was adequate and fair. Unless that finding is also clearly erroneous, there is little basis for claiming that the fiduciaries' reliance on Arthur Young's valuation was unreasonable or imprudent.

I respectfully dissent.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

FILED
MAR 4, 1997
Cathy A. Catterson, Clerk
U.S. COURT OF APPEALS

NEWMAN HOWARD; GILBERT LEON ALLEN; JOAN HOWARD; THEODORE H. POPE, as Representatives of Plan Participants Similarly Situated on Behalf of THE EMPLOYEE STOCK OWNERSHIP PLAN OF PACIFIC ARCHITECTS AND ENGINEERS INCORPORATED,

Plaintiffs-Appellants,

v.

EDWARD A. SHAY; MARTIN L. LEHRER; RICHARD L. SMITH; ALLEN SHAY; PACIFIC ARCHITECTS AND ENGINEERS, INC.,

Defendants-Appellees.

C.A. No. 93-56605
D.C. No. CV-91-00146-DT

ORDER

Before: FARRIS, Circuit Judge

Appellees' motion for stay of mandate pending petition for writ of certiorari is GRANTED.

The mandate of this court is stayed for a period of 30 days to allow for the filing of a petition for Writ of Certiorari. If the petition is filed, the mandate will be stayed pending the resolution of the Writ of Certiorari by the Supreme Court.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

FILED
FEB 13, 1997
Cathy A. Catterson, Clerk
U.S. COURT OF APPEALS

NEWMAN HOWARD; GILBERT LEON ALLEN; JOAN HOWARD; THEODORE H. POPE, as Representatives of Plan Participants Similarly Situated on Behalf of THE EMPLOYEE STOCK OWNERSHIP PLAN OF PACIFIC ARCHITECTS AND ENGINEERS INCORPORATED,

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EDWARD A. SHAY; MARTIN L. LEHRER; RICHARD L. SMITH; ALLEN SHAY; PACIFIC ARCHITECTS AND ENGINEERS, INC.,

Defendants-Appellees.

C.A. No. 93-56605

D.C. No. CV-91-00146-DT

ORDER

Before: FARRIS, O'SCANNLAIN, and TASHIMA,* Circuit Judges.

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* At the time of oral argument, Judge Tashima was a United States District Judge for the Central District of California, sitting by designation.

Appellees' motion for leave to file a reply to appellants' response to the petition for rehearing and suggestion for rehearing en banc, filed on January 6, 1997, is DENIED.

Judges Farris and Tashima vote to deny appellants' petition for rehearing. Judge Tashima votes to reject the suggestion for rehearing en banc, and Judge Farris so recommends. Judge O'Scannlain votes to grant appellants' petition for rehearing and to accept the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc and no active judge has requested a vote on whether to rehear the matter en banc. Fed. R. App. P. 35.

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

APPENDIX D

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

FILED
OCT 1, 1993
Clerk, U.S. District Court
Central District of California
By Deputy

NEWMAN HOWARD, et al.,
Plaintiffs,
vs.
EDWARD A. SHAY, et al.,
Defendants.

NO. CV 91-146 DT
CLASS ACTION

FINDINGS OF FACT AND CONCLUSIONS OF LAW

[Fed.R.Civ.P. Rule 52]

Trial in this matter was held from July 20 to August 27, 1993. Larry R. Feldman, Lester G. Ostrov, and Gerald J. Miller of Fogel, Feldman, Ostrov, Ringler & Klevens appeared on behalf of defendants. Raymond G. Kolts and Gary C. Nawa of Kolts and Nawa appeared on behalf of plaintiffs. Now, pursuant to Rule 52 of the Federal Rules of Civil Procedure, this Court makes the following Findings of Fact and Conclusions of Law:

FINDINGS OF FACT

1. Plaintiff and class representative Newman Howard is a resident of the State of Virginia, is a former employee of PAE, and was a participant in The Employee Stock Ownership Plan of Pacific Architects and Engineers Incorporated ("PAE ESOP") on November 9, 1988.

2. Plaintiff and class representative Joan Howard is a resident of the State of Virginia, is a former employee of PAE, and was a participant in PAE ESOP on November 9, 1988.

3. Plaintiff and class representative Gilbert Leon Allen is a resident of the State of California, is a former employee of PAE, and was a participant in PAE ESOP on November 9, 1988.

4. Plaintiff and class representative Theodore H. Pope is a resident of the State of California, is a former employee of PAE, and was a participant in PAE ESOP on November 9, 1988.

5. PAE is a corporation organized under the laws of the State of California, with its principal place of business in Los Angeles, California.

6. Defendant Edward A. Shay is president and chairman of the board of PAE, is and at all relevant times was a member of PAE's board of directors, and was a member of the administrative committee of PAE ESOP from 1974 through 1981 and 1986 through 1988.

7. Defendant Richard L. Smith is executive vice president and chief financial officer of PAE, is and at all relevant times was a member of PAE's board of directors, and was a member of the administrative committee of PAE ESOP from 1974 through 1988.

8. Defendant Martin L. Lehrer is executive vice president of PAE, is and at all relevant times was a

member of PAE's board of directors, and was a member of the administrative committee of the ESOP from 1986 through 1988.

9. Defendant Allen Shay is a vice president of PAE and is the son of defendant Edward A. Shay.

10. This is a class action brought under Rule 23 of the Federal Rules of Civil Procedure. Plaintiffs Newman Howard, Joan Howard, Gilbert Leon Allen, and Theodore H. Pope have been certified as class representatives by order dated May 6, 1992.

11. The plaintiff class is defined as follows under this Court's Order dated May 6, 1992: "All persons who were participants in or beneficiaries of the Employee Stock Ownership Plan of Pacific Architects and Engineers Incorporated on November 8 and 9, 1988, at the time of its purported termination, except those participants who are named individual defendants in the instant action."

12. PAE ESOP was adopted on December 27, 1972, effective January 1, 1972, and was amended on February 20, 1975, retroactive to its effective date as a condition of a favorable determination by the Internal Revenue Service.

13. PAE ESOP is an ESOP governed by the provisions of ERISA 29 U.S.C. § 1001, *et seq*.

14. PAE was the plan sponsor of PAE ESOP.

15. An amended and restated plan was adopted on December 6, 1976, to be effective as of January 1, 1976, and was amended from time to time thereafter.

16. The plan did not include a mandatory put option in favor of ESOP participants on November 9, 1988.

17. On November 9, 1988, the Board of Directors of PAE, with Edward A. Shay abstaining, adopted the resolutions terminating PAE ESOP and providing for the

distribution of all participants' account balances thereunder, as adjusted to the date of distribution, in a lump sum of cash as soon as practicable following the sale of shares of PAE stock by the ESOP.

18. On November 9, 1988, the ESOP administrative committee, with Edward A. Shay abstaining, voted to sell all of the PAE stock owned by the ESOP to the E. & A. Shay Irrevocable Trust, dated November 8, 1988, for $14.40 per share, or a total purchase price of $5,479,241.21.

19. Prior to November 9, 1988, PAE ESOP held a minority interest in PAE which consisted of approximately 38.05% of the common stock of PAE. The E. & A. Shay Living Trust owned approximately 60% of the common stock of PAE.

20. The E. & A. Shay Irrevocable Trust is an irrevocable trust established by Edward A. Shay and his wife on November 9, 1988, for the benefit of their children.

21. Following the sale of the stock, the ESOP administrative committee distributed cash in a lump sum to each participant based upon his or her accrued account balance at the purchase price of $14.40 a share.

22. The sale of the PAE stock held by the ESOP for $14.40 per share was made pursuant to the valuation of a minority interest in PAE performed as of November 9, 1988, by Arthur Young & Company, and a fairness opinion dated November 9, 1988, from Arthur Young & Company.

23. Arthur Young & Company was retained by the fiduciaries of PAE ESOP in September 1988 to conduct an independent fair market valuation and render a fairness opinion as to the possible sale of all or part of the PAE stock owned by PAE ESOP to Edward A. Shay or an entity established by him.

24. Following extensive interviews of major valuation firms, Arthur Young & Company was retained by the administrative committee of PAE ESOP in January 1988 to perform the annual valuation of the PAE stock held by the ESOP. The initial valuation, performed as of both December 31, 1987, and March 31, 1988, resulted in a per share price of $14.40.

25. In connection with its valuations, Arthur Young & Company asked for and received extensive documentation regarding PAE's operations, including PAE's audited financial statements, information regarding deposits, receivables, and marketable securities, listing of real properties and encumbrances thereon, current and updated independent appraisals of real estate, summaries of pending litigation and other contingent liabilities, listings of contracts (including starting and completion dates, contract terms, and billing and cost information), plan documents, and partnership and joint venture agreements.

26. In connection with its valuations, Arthur Young & Company was permitted to conduct extensive interviews with PAE officers and employees, including employees of K.K. Halifax, was permitted to inspect PAE real estate holdings, both directly and indirectly owned, and was permitted to interview the independent appraiser of Japanese real property directly or indirectly owned by PAE.

27. Defendants provided all relevant, material information to Arthur Young & Company regarding the ESOP and PAE's assets and operations and did not provide any false or misleading information to Arthur Young & Company.

28. In establishing the fair market value of the PAE stock held by the ESOP, Arthur Young & Company applied discounts or adjustments to the estimated gross value of the underlying assets owned directly or

indirectly by PAE, as follows: a 60% discount to K.K. Halifax, a joint venture in which PAE owned a 50% corporate share; a 40% to 50% minority interest discount on all real estate related interests including the post 60% discount residual value of K.K. Halifax; a market comparison valuation of the architectural and engineering and operations and maintenance business; and a 50% marketability discount.

29. The discounts or adjustments applied by Arthur Young & Company were appropriate, were not improper or excessive, and were adequately justified by Arthur Young & Company and by the testimony of experts offered by defendants.

30. The Arthur Young & Company valuation of $14.40 per share properly reflected the fair market value of the minority interest in PAE held by the PAE ESOP.

31. The sale of the PAE stock by the PAE ESOP to the E. & A. Shay Irrevocable Trust was based upon a valuation performed by an independent appraiser as required by the Internal Revenue Code, 26 U.S.C. § 401(a)(28)(c).

32. In addition to the valuation report, Arthur Young & Company issued a fairness opinion dated November 9, 1988, in which Arthur Young & Company considered the actual transaction in question, analyzed the consideration to be paid to the plan participants and opined that $14.40 per share "would be fair to the participants/beneficiaries of Pacific Architects and Engineers Incorporated's Employee Stock Ownership Plan."

33. The Arthur Young & Company valuation report and fairness opinion of November 9, 1988, presented a fair evaluation of the transaction in question to the plan fiduciaries.

34. The continued liquidity of the ESOP and the possible future inability to purchase shares from plan

participants and beneficiaries were the prime reasons the plan fiduciaries voted to sell the PAE stock to the E. & A. Shay Irrevocable Trust on November 9, 1988.

35. The sale of the PAE stock by the PAE ESOP to the E. & A. Shay Irrevocable Trust was for fair market value determined in good faith.

36. The per share price of $14.40 received for the PAE ESOP shares by the plan participants on November 9, 1988, was full, fair and adequate consideration.

37. The sale of the PAE stock by the PAE ESOP to the E. & A. Shay Irrevocable Trust was for adequate consideration, as defined in 29 U.S.C. § 1002(18)(B).

38. Defendant Edward A. Shay owned 100% of the stock of PAE at the time of formation of the ESOP in 1972.

39. Defendant Edward A. Shay sold 40% of the stock of PAE to the ESOP per an agreement of sale dated September 18, 1974.

40. The price paid by the ESOP for the stock sold by defendant Edward A. Shay was pursuant to a report by Bangert & Company dated September 19, 1974.

41. Defendant Edward A. Shay sold 40% of the stock of PAE to the ESOP for $4,269,162.00.

42. Any findings of fact that are conclusions of law shall be considered to be denominated as such.

CONCLUSIONS OF LAW

1. This is an action under the Employee Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C. §§ 1001 *et seq.* This Court has jurisdiction of this action under 28 U.S.C. § 1331. Venue is proper under 28 U.S.C. § 1391(b).

2. Under ERISA, there is a presumption of undue influence and fraud where the assets of an ESOP are sold to a party in interest, which may be rebutted by evidence that the sale was for adequate consideration. 29 U.S.C. §§ 1106(a), 1108(b)(12), and 1108(e)(1) and (2); *Donovan v. Cunningham*, 716 F.2d 1455, 1464-65 (5th Cir. 1983).

3. California Corporations Code Section 1800 *et seq.*, dealing with liquidation valuation methodology in situations involving the involuntary dissolution of corporations, is preempted by ERISA, 29 U.S.C. § 1144(a). *Corcoran v. United Health Care Inc.*, 965 F.2d 1321, 1328 (5th Cir. 1992); *Thomas v. Burlington Indus., Inc.*, 763 F. Supp. 1570, 1572 (S.D. Fla. 1991); *Helms vs. Monsanto Co. Inc.*, 728 F.2d 1416 (11th Cir. 1984); *Pilot Life Ins. Co. v. Dedeaux*, 481 U.S. 41, 45, 107 S.Ct. 1549, 1552 (1987); *Fort Halifax Packing Co. v. Coyne*, 482 U.S. 1, 9, 11, 107 S.Ct. 2211, 2216, 2217 (1987). ERISA mandates the application of fair market value, not liquidation value. *See* 26 U.S.C. § 401(a)(28)(c); *Sommers Drug Store Co. Employee Profit Sharing Trust v. Corrigan Enterprises, Inc.*, 793 F.2d 1456, 1461 (5th Cir. 2986), *cert. denied*, 479 U.S. 1089 (1987).

4. Under ERISA, a plan fiduciary shall discharge his or her duties with respect to a plan in the interest of the participants and beneficiaries with the care, skill, prudence and diligence of a prudent fiduciary under the same circumstances, and in accordance with documents and instruments governing the plan. 29 U.S.C. § 1004(A)(1); *Katsaros v. Cody*, 744 F.2d (2d Cir. 1984); *Donovan v. Walton*, 609 F. Supp. 1221 (D. Fla. 1985), *aff'd* sub nom. *Brock v. Walton*, 794 F.2d 586 (11th Cir. 1986).

5. Defendants discharged their duties with respect to the PAE ESOP in the interest of the participants and

beneficiaries with the care, skill, prudence and diligence of a prudent fiduciary under the same circumstances and in accordance with documents and instruments governing the plan.

6. The PAE ESOP fiduciaries did not breach their fiduciary duties in their reliance upon the Arthur Young & Company valuation report and fairness opinion and their decision to sell the PAE ESOP stock to the E. & A. Shay Irrevocable Trust for $14.40 per share.

7. The sale of the PAE stock by the PAE ESOP to the E. & A. Shay Irrevocable Trust was for fair market value determined in good faith.

8. The per share price of $14.40 received for the PAE ESOP shares by the plan participants on November 9, 1988, was full, fair and adequate consideration. Utilizing the "Business Judgment" Rule, this Court cannot find that the PAE ESOP committee breached any fiduciary duty in relying on the Arthur Young & Company independent valuation and fairness opinion in completing the transaction in question at the $14.40 per share price rather than at some point between $14.48 and $28.80. To do otherwise would be too speculative and would place the Court in the inevitable position of remaking and renegotiating the transaction.

9. The sale of the PAE stock by PAE ESOP to the E. & A. Shay Irrevocable Trust was for adequate consideration, as defined by 29 U.S.C. § 1002(18)(B).

10. Defendant Edward A. Shay did not breach his fiduciary obligations under ERISA.

11. Defendant Martin L. Lehrer did not breach his fiduciary obligations under ERISA.

12. Defendant Richard L. Smith did not breach his fiduciary obligations under ERISA.

13. Defendant Allen Shay did not breach his fiduciary obligations, if any, under ERISA.

14. Defendant Pacific Architects and Engineers Incorporated did not breach its fiduciary obligations under ERISA.

15. Any conclusions of law that are findings of fact shall be considered denominated as such.

DATED: OCTOBER 1, 1993

/s/ DICKRAN TEVRIZIAN
DICKRAN TEVRIZIAN
United States District Judge

I hereby certify that this document was served by First Class mail, postage prepaid, to all counsel (or parties) at their respective most recent address of record in this action on this date.

OCTOBER 1, 1993
DATED

/s/ MENNA NEUMAIER
DEPUTY CLERK

APPENDIX E

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

FILED
SEP 15, 1993
Clerk, U.S. District Court
Central District of California
By Deputy

NEWMAN HOWARD, et al.,
Plaintiffs,
vs.
EDWARD A. SHAY, et al.,
Defendants.

NO. CV- 91-146 DT

MEMORANDUM OF DECISION

The above-entitled action came on regularly for trial before the Court from July 20, 1993, though August 27, 1993.

Kolts & Nawa by Raymond G. Kolts, Esq. and Gary C. Nawa, Esq. appeared for Plaintiffs, NEWMAN HOWARD, GILBERT LEON ALLEN, JOAN HOWARD and THEODORE H. POPE as representatives of plan participants similarly situated on behalf of THE EMPLOYEE STOCK OWNERSHIP PLAN OF PACIFIC ARCHITECTS AND ENGINEERS INCORPORATED.

Fogel, Feldman, Ostrov, Ringler & Klevens by Larry R. Feldman, Esq., Lester G. Ostrov, Esq. and Gerald J. Miller, Esq. appeared for Defendants, EDWARD A. SHAY, MARTIN C. LEHRER, RICHARD L. SMITH,

ALLEN SHAY, and PACIFIC ARCHITECTS AND ENGINEERS, INCORPORATED.

Evidence was presented to the Court sitting without a jury. Oral argument made on behalf of the respective parties was presented and considered by the Court. The Court, now feeling fully advised, rules as follows:

1. Judgment for defendants on all causes of action;

2. Each party to bear their own costs and attorneys' fees;

3. Counsel for defendants to prepare proposed "Findings of Fact" and "Conclusions of Law" in accordance with this ruling; and,

4. Counsel for defendants to prepare a proposed "Judgment" in accordance with this ruling.

I.

STATEMENT OF FACTS

This is a class action for equitable and monetary relief brought pursuant to §§ 502(a)(2) and (3) of the Employee Retirement Income Security Act of 1974, 29 U.S.C. §1001, et seq. (ERISA). The named plaintiffs Newman Howard, Joan Howard, Gilbert Allen and Theodore Pope are former employees of defendant Pacific Architects and Engineers, Inc. ("PAE") as well as former participants in PAE's Employee Stock Ownership Plan ("ESOP"). This matter was certified as a class action on May 6, 1992, and said plaintiffs are class representatives of the plan participants similarly situated as of November 9, 1988. Plaintiffs' action alleges that Edward A. Shay, Martin L. Lehrer, Richard L. Smith and Allen Shay breached their fiduciary duties as trustees and/or corporate officers or directors of PAE by engaging in self-dealing. Plaintiffs further allege that

defendants improperly sold the sole asset, namely approximately 38.05% of PAE stock held by the PAE Employee Stock Ownership Plan. The complaint also names PAE as a defendant.

Allen Shay is the son of Edward Shay and the principal beneficiary of the E. & A. Shay Irrevocable Trust (the "Trust") which was allegedly created for the sole purpose of acquiring the PAE stock from the PAE Employee Stock Ownership Plan.

Edward Shay was an ESOP fiduciary, an owner of stock possessing 50% or more of the voting power of PAE and a party in interest. As the son of a party in interest, Allen Shay is also a party in interest under 29 U.S.C. § 1002(14)(F) and 29 U.S.C. § 1002(15).

Plaintiffs' Third Amended Complaint contains the following claims for relief against all defendants:

1. Breach of Fiduciary Duty — Sale of Stock at Below Market Value;

2. Breach of Fiduciary Duty — Sale of Stock and Termination of the PAE Employee Stock Ownership Plan;

3. Breach of Fiduciary Duty — Engaging in Prohibited Transactions; and,

4. Breach of Fiduciary Duty — Failure to Discharge Duties in Accordance with the Documents and Instruments Governing the PAE Employee Stock Ownership Plan.

On November 9, 1988, the administrative committee of The Employee Stock Ownership Plan of Pacific Architects and Engineers Incorporated ("PAE ESOP") voted to sell the 380,502.862 shares of PAE stock (38.05% of the issued and outstanding 1,000,000 shares) held by the ESOP to the E. & A. Shay Irrevocable Trust for $14.40 per share, or for a total sum of $5,479,241.21. The sale followed and was based upon a valuation

performed by Arthur Young & Company, which included a review of company financial records, analysis of the company's present and future business operations, and independent appraisals of company real estate and equity interests (Exhibit 2548). That valuation resulted in a fair market value of $14.40 per share, the highest value ever ascribed to the PAE stock held by the ESOP, and was accompanied and supported by a fairness opinion from Arthur Young & Company (Exhibit 1911).

II.

A REBUTTABLE PRESUMPTION OF UNDUE INFLUENCE AND FRAUD EXISTS FOR THE TRANSACTION IN QUESTION.

ERISA Section 406(a) (29 U.S.C. 1106(a)) provides that:

(1) A fiduciary with respect to the plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect — (A) sale or exchange, or leasing, of any interest between the plan and the party in interest . . . (B) transfer to, or used by or for the benefit of, a party in interest, of any assets of the plan.

A party in interest is defined at ERISA Section 3(14) to include any fiduciary of an employee benefit plan, and owner of 50% or more of the company's stock and a relative of a fiduciary or owner of 50% or more of the company's stock.

Section 408(b)(12) of ERISA, 29 U.S.C. § 1108(b)(12), creates a basic exception to the prohibitions against dealings with parties in interest contained in Section 406(a), 29 U.S.C. § 1106(a). Section 408(b)(12)

provides in pertinent part that Section 406(a) shall not apply to "the sale by a plan to a party in interest . . . of any stock . . . constituting a qualifying employer security." Similarly, 29 U.S.C. §§ 1108(e)(1) and (2) provide in pertinent part that "Sections 1106 and 1107 of this title shall not apply to the acquisition or sale by a plan of qualifying employer securities" if "such acquisition, sale or lease is for adequate consideration" and if no commission is charged with respect to the sale. See also 29 C.F.R. §§ 2550.408e(a), (c) (sale of qualifying employer securities shall include any disposition for value, and shall be exempt from the prohibitions of Sections 1106 and 1107).

Based upon the joint pre-trial conference order filed on February 22, 1993, specifically paragraph 5, subparagraphs (1) through (18) this Court found at the commencement of this trial that a rebuttable presumption of undue influence and fraud existed with respect to the sale of the PAE ESOP shares of PAE stock held by the ESOP to the E. & A. Shay Irrevocable Trust. The Court therefore required that the defendants prove to this Court that the consideration that the plan participants received from the disposition of the PAE ESOP shares of PAE was full, fair and adequate consideration.

III.

CALIFORNIA CORPORATIONS CODE SECTION 1800, ET SEQ. IS PREEMPTED BY ERISA AND CANNOT FORM THE BASIS FOR A CLAIM OF BREACH OF FIDUCIARY DUTY.

Unlike most statutes, ERISA describes the extent of its preemption of state law. ERISA § 514(a) announces that, with certain exceptions, "the provisions of (title I)

and (title IV) shall supersede any and all state laws insofar as they may now or hereafter relate to any employee benefit plan" covered under ERISA § 4. "State law" includes "all laws, decisions, rules, regulations, or other State action having the effect of law"; "State" includes political subdivisions and "any agency or instrumentality which purports to regulate, directly or indirectly, the terms and conditions of employee benefit plans covered by (title I)." ERISA § 514(c). Section 514 is the most expansive preemption provision contained in federal law. It has few exceptions.

Absent a specific "savings clause" 29 U.S.C. § 1144(a) provides that the fiduciary duty provisions of ERISA "shall supersede any and all state laws insofar as they may now or hereinafter relate to any employee benefit plan . . ." Federal courts have held that the "deliberately expansive" language of 29 U.S.C. § 1144 (a) is to be "construed extremely broadly" to "preempt all state laws falling within its sphere, regardless of whether they conflict with any specific provisions of the act." (*Corcoran v. United Health Care Inc.*, 965 F.2d 1321, 1328 (5th Cir. 1992); *Thomas v. Burlington Industries Inc.*, 763 F.Supp. 1570, 1572 (S.D. Florida 1991) and to preclude both statute and case law. *Helms v. Monsanto Company Inc.*, 728 F.2d 1416 (11th Cir. 1984); *see also Pilot Life Insurance Company v. Dedeaux*, 481 U.S. 41, 45, 107 S.Ct. 1549, 1552 (1987).)

In addition, it is evident that the purpose of the ERISA preemption statute is to prevent the exact type of application of state law urged by plaintiffs in the present action. As the Supreme Court stated in *Fort Halifax Packing Co. v. Coyne*, 482 U.S. 1, 107 S.Ct. 2211 (1987):

> "ERISA's preemption provision was prompted by recognition that employers establishing and maintaining employee benefit plans are faced

> with the task of coordinating complex administrative activities. A patch-work scheme of regulation would introduce considerable inefficiencies in benefit program operation, which might lead those employers with existing plans to reduce benefits, and those without such plans to refrain from adopting them. Pre-emption ensures that the administrative practices of a benefit plan will be governed by only a single set of regulations."

Id. at 11, 107 S.Ct. at 217. The Court added that the Congressional intent in enacting Section 1144(a) was to establish a "uniform administrative system" which would be thwarted if, for instance, a plan were required to "comply with certain fiduciary standards in some states but not in others." *Id.* at 9, 107 S.Ct. at 2216.

Here, the application of the valuation methodology of Cal. Corps. Code Section 1800 *et seq.* as urged by plaintiffs would thwart and confuse the above principles and in fact negate applicable provisions of federal law. The Internal Revenue Code specifically requires that valuations of pension plans be performed by an independent appraiser, using fair market value. *See* 26 U.S.C. § 401(a)(28)(c). Moreover, the federal courts have interpreted the requirement that fiduciaries obtain "adequate consideration" for plan assets to mandate fair market value, *not* liquidation value. *See Sommers Drug Stores Co. Employee Profit Sharing Trust v. Corrigan Enterprises, Inc.*, 793 F.2d 1456, 1461 (5th Cir. 1986), *cert denied*, 479 U.S. 1089 (1987) in which the Fifth Circuit, in holding their fair market value was the appropriate standard, found the valuation by plaintiffs' expert based on liquidation or asset value to be "so conclusory and lacking in analysis that no jury would reasonably have relied on it." By contrast, plaintiffs' theory would negate the above law by requiring Arthur Young &

Company to instead apply liquidation value in valuing the shares of stock held by an ESOP. Moreover, plaintiffs' argument would subject valuations of ERISA plans to a patch-work, composed of 50 sets of state corporate statutes governing valuation methodologies on dissolution, contrary to the express intent of Congress to promote uniformity in the measure of benefit payments and the standards imposed upon fiduciaries under ERISA. On March 8, 1993, at a hearing on the parties' respective summary judgment motions, this Court specifically ruled that Section 1800 *et seq.* is preempted by ERISA and cannot form the basis for plaintiffs' claims of breach of fiduciary duty.

IV.

THE ARTHUR YOUNG & COMPANY VALUATION AND FAIRNESS OPINION.

The evidence presented to the Court indicated that the international public accounting firm of Arthur Young & Company was selected in September of 1988 by the PAE ESOP fiduciaries to conduct an independent fair market valuation and render a fairness opinion because it had the expertise, personnel and resources, including an office in Tokyo, Japan, to value PAE's significant directly and indirectly owned real estate holdings in Japan. Arthur Young & Company had been informed in July of 1988 of the possibility that Edward A. Shay, as president and chairman of the board of PAE, might be interested in purchasing the PAE stock held by the ESOP either directly himself or indirectly through a family controlled entity. Earlier, in January 1988, the administrative committee had engaged Arthur Young & Company to perform the 1987 annual valuation of the PAE stock held by the ESOP. That engagement

followed extensive interviews of major valuation firms. That initial valuation, performed as of both December 31, 1987, and March 31, 1988, resulted in a per share price of $14.40. The most recent (1986) prior valuation by Emco Financial Ltd. had valued the PAE stock at $11.07 per share.[1]

In connection with its valuations, Arthur Young & Company asked for and received extensive documentation regarding PAE's operations.[2] Defendants also permitted Arthur Young & Company to conduct extensive interviews with PAE officers and employees, and to inspect PAE real estate holdings both directly and indirectly owned. In particular, James G. Wolf of Arthur

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[1] The January 1988 selection of Arthur Young followed an actuarial study of the ESOP conducted on behalf of PAE by Private Capital Corporation. Although directed primarily at the long-term future of the ESOP (and in particular the ESOP's financial ability to continue to make cash distributions to vested participants), Private Capital also recommended replacing or supplementing Emco with a firm better able to value Japanese real estate.

[2] Those documents included PAE's articles and bylaws, PAE's audited financial statements, information regarding time deposits, receivables, and marketable securities, listing of PAE's real properties and encumbrances thereon, summaries of pending litigation and other contingent liabilities, loans involving the company, listings of contracts (including starting and completion dates, contract terms, and billing and cost information), Plan documents, the ESOP Forms 5500 filed with the Labor Department, and information regarding trends in Japanese real estate. Defendants also provided Arthur Young with documents regarding specific corporate transactions and holdings, including copies of partnership and joint venture agreements, including the operations and ownership agreements for K.K. Halifax, a Japanese real estate company of which PAE was half owner. Defendants also provided Arthur Young with existing independent appraisals of Japanese real estate owned by PAE and by Halifax, and independent appraisals of domestic real estate owned by PAE. Defendants, at Arthur Young's request, also commissioned updates of these appraisals by independent appraisers.

Young traveled to Japan in September 1988 and reviewed the Japanese real estate market, met with the appraisers of PAE's real property in Japan, toured such properties, and met with officials of PAE and Halifax. Based upon a review of the evidence this Court can find nothing wrong with the selection and procedure employed by Arthur Young & Company.

At the outset it should be stated that the plaintiffs have not offered any evidence to dispute the gross value of the underlying assets owned directly or indirectly by PAE. In fact, during closing argument this question was specifically asked of plaintiffs' counsel who conceded that they were not attacking the gross value of the underlying assets owned directly or indirectly by PAE. Plaintiffs are, however, disputing the minority and marketability discounts that were applied by Arthur Young & Company to eventually arrive at the $14.40 per share price of the PAE ESOP owned stock.

In its valuation methodology Arthur Young & Company applied a 60% discount to K. K. Halifax, a joint venture in which PAE owned a 50% corporate share. Arthur Young & Company then applied a 40% to 50% minority interest discount on all real estate related interests including K.K. Halifax. PAE's architectural and engineering (A&E) and operations and maintenance (O&M) business was valued on the basis of a market comparisons approach. Finally, Arthur Young & Company applied a 50% marketability discount. The net effect of these multiple discounts was to reduce the value of a corporation having appraised gross assets of approximately $83 million to $14.4 million.

Arthur Young & Company's stated rationale for the application of all of these discounts was that they were appropriate and were necessary to induce an outside third party purchaser (under the willing buyer-willing seller test of Revenue Ruling 59-60) to consider buying

the approximately 38.05% minority interest in PAE owned by the ESOP. In the body of the valuation report (Exhibit 2548), Arthur Young & Company specifically details and articulates its reasoning and rationale behind each of the discounts taken. At trial, defendants' witnesses, both percipient and expert, clearly articulated the propriety and reasoning for each of the discounts taken. Plaintiffs' experts on the other hand were not able to articulate any logical or legal reason for disallowing the discounts taken by Arthur Young & Company. Plaintiffs' experts for the most part disagreed with the discounts taken but couldn't offer any objective persuasive evidence or reasons as to why the discounts should not be applied.

In addition to the Arthur Young & Company valuation report (Exhibit 2548), Arthur Young & Company issued a fairness opinion under date of November 9, 1988 (Exhibit 1911) regarding the transaction in question as to the plan participants of the PAE ESOP. This fairness opinion analyzed the consideration to be paid to the plan participants and opined that $14.40 per share paid to the said plan participants "would be fair to the participants/beneficiaries of Pacific Architects and Engineers Incorporated's Employee Stock Ownership Plan."

Upon review of the evidence, this Court cannot find that the minority discounts taken by Arthur Young & Company were improper or excessive. Further, this Court finds that all fiduciaries of the PAE ESOP and corporate officers and directors of PAE furnished all material information regarding the ESOP and the assets and operations of PAE to Arthur Young & Company.

What has troubled this Court throughout the duration of this case is the 50% discount taken for marketability. Defendants' financial witnesses, both expert and percipient, all testified that a discount for marketability should be utilized to determine fair market value. A

marketability discount is defined as a discount for illiquidity. However, because the E. & A. Shay Irrevocable Trust was the disclosed ultimate purchaser of the PAE ESOP stock, this Court has always questioned the appropriateness of a 50% discount for marketability. This Court is of the opinion that the Arthur Young & Company valuation report set a price range on the per share price of the PAE ESOP stock. The ceiling on the price range would be $28.80 per share (pre-marketability discount) and the floor of the price range would be $14.40 per share. Stated another way, this Court is of the opinion that no sophisticated third party investor would ever pay over $28.80 per share and no fiduciary would ever sell the ESOP stock for less than $14.40 per share.

Defendants' eminently qualified expert witness, Dr. Shannon Pratt, testified that the approaches and methodologies utilized by Arthur Young & Company in the preparation of their valuation report complied with the uniform standards of the appraisal process in utilizing the minority and marketability discounts. Dr. Pratt further testified that a marketability discount of at least 35% should be applied for restricted stock of publicly traded corporations. In addition, since the ESOP held stock of PAE was not publicly traded and did not contain a mandatory "put option," an additional 15% discount would be warranted for a total marketability discount of 50%. A "put option" is defined as a specific right to sell at a specified price for a specified time. Here the plan participants did not have the mandatory right to "put" the ESOP owned stock to the company. In fact, if PAE didn't fund the ESOP, there would be no liquidity in the plan and the plan beneficiaries could be left holding paper certificates. In essence, Dr. Pratt opined that a 50% discount taken for marketability was proper under

these circumstances. Dr. Pratt further justified the 50% marketability discount as follows:

1. Lack of dividend paying capacity caused by insignificant historical earnings;
2. Insufficient cash flow of PAE;
3. PAE's return on equity was historically less than 1%; and,
4. PAE's price earnings ratio for the period 1985 through 1989 was approximately 36:1, whereas the Standard & Poor's combined price earnings ratio for publicly traded companies for the same period was approximately 18:1.

This Court, based upon the evidence presented, finds that both the Arthur Young & Company valuation report and fairness opinion of November 9, 1988, presented a fair evaluation of the transaction in question to the plan fiduciaries and was in fact performed by an independent appraiser as is required by I.R.C. § 401(a)(28)(c) (26 U.S.C.A. § 401(a)(28)(c)).

V.

THE PLAN FIDUCIARY — CORPORATE OFFICER/DIRECTORS'S DILEMMA.

"Fiduciary" and "fiduciary duty" are concepts used in the law of trusts and other legal principles where one individual assumes special responsibility for another. All fiduciaries owe a duty of loyalty, virtually as a matter of definition, to the persons for whom they are specially responsible. All fiduciaries similarly owe a duty of care. Yet there are also differences, resulting from the need to adjust fiduciary concepts to special features and concerns. Fiduciary law is adaptable, not monolithic, especially where ESOP's are involved. *See*

Donovan v. Cunningham, 716 F.2d 1455, 1465 (5th Cir. 1983).

ERISA characterizes the persons responsible for the management and operation of a plan as "fiduciaries." What does this mean?

For several reasons, a strict trust-law model for plan fiduciaries would not work. One reason is that trust law takes a "one size fits all" approach. It acknowledges only one kind of fiduciary, the trustee, who (perhaps along with co-trustees) has all significant responsibility for administering the trust. The trustee, in fact, is under a duty to avoid delegating responsibility. This constrictive approach ill suits ESOP plans which are ongoing and often complex. As a result of their size and complexity, plans often need to divide managerial, financial and administrative responsibility.

ERISA recognizes this. It treats responsibility for plan management and operation as divisible and allows for the possibility of many plan fiduciaries, each with their own area of specialization: "a plan may have as few or as many fiduciaries as is necessary for its operation and administration." 29 C.F.R. § 2509.75-8. It also permits extensive delegation of fiduciary responsibility, making the delegatees fiduciaries as well. Most significantly, it provides a highly functional, general definition of "fiduciary" that permits adjustments for the individual circumstances of each plan. ERISA § 3(21)(A). In addition, all valuations of employer securities that are not readily tradeable on an established market must be performed by an independent appraiser, 26 U.S.C.A. § 401(a)(28)(c).

A second reason that a trust-law model would be inappropriate is that traditional trustees and plan fiduciaries have very different reasons for their existence. Traditional trustees exist to carry out the aims of the settlor. To that end, they are endowed with powers

used to implement the settlor's intent. Traditional trustees may be viewed primarily as bearers of powers, the exercise of which it is the function of trust law to oversee and control. Plan fiduciaries, however, do not exist to carry out a settlor's intent. They exist to implement an ongoing program of providing benefits and to safeguard benefit interests. ERISA does not view plan fiduciaries as bearers of powers so much as bearers of duties: to the plan and to participants and beneficiaries. It is the purpose of ERISA's fiduciary rules to regulate the fulfillment of those duties.

ERISA § 408(c)(3) expressly permits a plan fiduciary to be the employer of the participants, or one of its officers, employees, agents or other representatives. Since an overriding purpose of ERISA is to safeguard employee expectations created by the employer, allowing the employer and its representatives to be fiduciaries might seem a case of allowing the fox into the hen house. But matters are not so simple. In the language of one Congressional report, there is a "symbiotic relationship existing between the employer and the plan covering his employees." (4869). This means two things.

First, most employers who implement benefit plans surely want them managed properly and want the plan purposes fulfilled. The plan was likely established, at least in part, to serve the employer's own business purposes; and those purposes commonly involve the creation or maintenance of good relations with employees. It can be argued that, although some employers may misuse their position as fiduciaries, most will not wish to alienate employees by mismanaging or abusing the plan. *See Van Boxel v. Journal Co. Employees Pension Trust*, 836 F.2d 1048 (7th Cir. 1987).

Second, in the end, it is the employer's money that is used to pay benefits and expenses. An employer will legitimately want to maintain oversight of plan funds

both to ensure that they are managed properly and to control administrative costs. If ERISA did not permit employers and their representatives to serve as fiduciaries, employers might be less willing to establish plans, thereby defeating a different purpose of the statute. It is apparent that Congress was aware of potential conflicts when it permitted a plan fiduciary to be an officer/director of the plan sponsor.

ERISA § 404(a)(1) requires a fiduciary to "discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and (A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan . . ." This is ERISA's statement of the duty of loyalty, arguably the central duty of any fiduciary. It is often called the exclusive benefit rule.

On its surface, the ERISA duty of loyalty is straightforward. A fiduciary must act with one and only one purpose and must act to further one and only one interest. However, there are subtle difficulties for interpretation and application.

Although the duty is to act solely in the interest of participants and beneficiaries, under the most plausible interpretation it is owed to the plan as a whole and not to the individual participants and beneficiaries. This interpretation seems compelled by two considerations.

First, the Supreme Court has unequivocally held that any remedy for breach of fiduciary duty inures to the benefit of the plan as a whole. Individual participants and beneficiaries may not recover under ERISA §§ 409 and 502(a)(2) for injuries to themselves. *Massachusetts Mutual Life Insurance Co. v. Russell*, 473 U.S. 134, 105 S.Ct. 3085 (1985). The basis for the holding is the language of section 409. That provision allows redress only of "losses to the plan" resulting from breaches of

fiduciary duty and provides only for remedies that make the plan whole or otherwise serve its needs. It does not appear to allow redress of losses to individuals. If only the plan can recover for a breach of fiduciary duty, then the fiduciary duties in question would seem owed only to the plan.

Second, situations may arise where different participants or groups of participants have conflicting interests concerning some aspect or activity of the plan. For example, if a plan is seriously underfunded, the payment of benefits to one participant may deplete the resources available to pay benefits to others. Or, for another example, current employees, concerned more about their jobs than about retirement income, might want the plan to make a sizeable loan to the employer's largest customer that would help keep it afloat and thus maintain levels of their own employment. Retirees, on the other hand, concerned only about their retirement benefits, might object to a large loan to a financially troubled enterprise. Other conflicts can easily be imagined. Both the legislative history and the case law make it clear that a fiduciary cannot favor individual participants or beneficiaries or groups of them. Where there are conflicts among such interests, the fiduciary must determine which course best serves the purpose of the plan in providing benefits to the participants and beneficiaries as a whole. *See Morse vs. Stanley*, 732 F.2d 1139 (2d Cir. 1984); *Winpisinger vs. Aurora Corp. of Illinois*, 456 F.Supp. 559 (1978). ERISA's duty of loyalty implicitly includes a duty of impartiality which prevents fiduciaries from favoring individual interest over the interest of the plan.

The fact that the employer of the participants (or its representative) may serve as a fiduciary creates obstacles to the principled application of the exclusive benefit rule. An often difficult problem is that of determining

which conduct by the employer or its representative is fiduciary conduct subject to ERISA's fiduciary duties. The conduct, to be fiduciary conduct, must involve plan management or administration (the problem rarely arises with respect to investment advice or asset management). One thus needs criteria for identifying the kinds of conduct that amount to plan management or administration.

It is clear that the establishment of a plan is not a fiduciary function. *Berlin v. Michigan Bell Telephone Co.*, 858 F.2d 1154 (6th Cir. 1988). Nor is termination or amendment. *Hozier v. Midwest Fasteners, Inc.*, 908 F.2d 1155 (3rd Cir. 1990); *Young v. Standard Oil (Indiana)*, 849 F.2d 1039 (7th Cir. 1988).

Courts have found it troublesome to categorize employer statements about impending changes in the status of a plan (e.g., termination). One case held misrepresentations by an employer-administrator about the impending reactivation of an early retirement program to be conduct governed by the fiduciary rules. *Berlin v. Michigan Bell Telephone Co.*, 858 F.2d 1154 (6th Cir. 1988). In another case, however, the court found that the employer-administrator was not subject to fiduciary rules in its failure to disclose an impending plan termination. *Payonk v. HMW Industries, Inc.*, 883 F.2d 221 (3rd Cir. 1989).

An employer-fiduciary may be faced with a situation in which its conduct as a fiduciary might affect, even necessarily will affect, the employer's business interests. Good examples come from the recent period of intense corporate takeover activity. A recurring issue was whether an employer-fiduciary had violated the duty of loyalty by investing plan funds in a way that furthered its own interest in either pursuing or resisting a takeover. The two leading cases are *Donovan v. Bierwirth*, 680 F.2d 263 (2nd Cir. 1982), *cert. denied* 459 U.S. 1069

and *Leigh v. Engle*, 727 F.2d 113 (7th Cir. 1984), which take similar, yet different approaches.

Bierwrith involved a hostile tender offer for a majority of common stock of the employer. The same persons who, as corporate officers, were fighting the tender offer had responsibility, as plan fiduciaries, to decide whether the plan should tender its share of employer stock. The virtual impossibility of their ignoring the employer's interest was obvious. The fiduciaries decided, not only not to tender, but to purchase more shares of employer stock. The court found this conduct to violate ERISA's duties of loyalty and prudence.

The court rejected two rules that might have simplified the analysis. First, the court held that it was not a *per se* breach for the fiduciaries' decision to have advanced the employer's interest. In the court's analysis, a fiduciary's decision might be solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits, yet still incidentally benefit the employer. Second, the Department of Labor had argued that the only proper course for the fiduciaries was to have resigned, so that neutral fiduciaries could be appointed to decide what the plan should do. The court was receptive to the argument. However, it found it unnecessary to impose such a strict requirement because there were other reasons to find a breach of fiduciary duty in the case.

The court's rejection of bright-line tests demanded that it find some way to distinguish illegitimate conduct that advances the employer's interest from legitimate conduct that does so. The court rested the distinction on procedural grounds. It focused on the extent to which the fiduciaries followed procedures designed to ensure that whatever decision they reached would be in the participants' and beneficiaries' best interest and would not be tainted by consideration of the employer's

interest. There, serious and obvious irregularities undermined the decision making process, including the failure promptly to convene a meeting of plan trustees, the failure to solicit the advice of independent counsel, and the swift and superficial decision making regarding the purchase of additional shares. Thus it was easy to find liability.

It is not clear why the court chose a wholly procedural approach. The problem with such an approach is that it virtually conflates the duty of loyalty with the duty of prudent decision making. In fact, despite the court's repeated reference to the duty of loyalty, it could have decided the case on prudence grounds alone. The question the court left open is what the result would have been had the fiduciaries acted prudently but still decided to purchase additional shares. Would there be any basis for finding a breach of the duty of loyalty?

Leigh goes some way toward answering that question. There, the plan fiduciaries were employees or agents of the plan sponsor, which was controlled by an individual financier. The fiduciaries' positions in both the company and the plan were dependent on the financier. The fiduciaries consistently invested plan funds in corporations that the financier was trying to acquire. The question was whether this conduct violated the duty of loyalty. Prudence was not explicitly in issue.

The court, like the one in *Bierwirth*, agreed that for employer-fiduciaries to invest plan assets in a way that advances the employer's interest is not a *per se* violation of ERISA. It also agreed with the Department of Labor's suggestion that the preferred course in cases like the one at hand is for interested fiduciaries to resign in favor of neutral ones. Such a course would reduce the risk of improper decision making, simplify review by courts, and "calm the fears of plan beneficiaries who might otherwise perceive the need to resort to the courts

in order to ensure the safety of their entitlements." However, as in *Bierwirth*, the court opted for an approach requiring examination of the facts.

Yet the approach differed in that it was not wholly procedural. Instead, the court took the fundamental issue to be the actual independence of the fiduciaries' decision making. The court held that, to evaluate independence, it had to closely examine the facts surrounding an alleged violation. Such facts include (but are not necessarily limited to) the risks of conflicts of interest, the nature of the investigation made by the fiduciaries, and the extent of congruence between the fiduciaries' decisions for the plan and the employer's interest. In *Leigh*, a telling factor in the court's finding of liability was the long-term congruence between fiduciary and employer decision making, despite the divergence of plan and employer interests. Thus, unlike as in *Bierwirth*, the court was concerned to find the fiduciaries' true motive. The problem, however, is that motives are inevitably mixed and complex.

So long as persons who represent interests different from those of participants and beneficiaries can be fiduciaries, there will be a problem of distinguishing legitimate from illegitimate decision making. But the problem does not result solely, or even primarily, from the fact that the fiduciary represents those other interests. *Every* fiduciary is a person with a complex set of personal interests and relationships that he will never be able to put entirely out of mind. Instead, the problem results from ERISA's extreme requirement that fiduciaries act *solely* in the interest of participants and beneficiaries. If taken literally, this requirement is probably impossible to meet in any situation calling for judgment. Where a fiduciary has a choice between several courses of action, all of which arguably would be in the interest of participants and beneficiaries, they

must rely on other considerations to break the tie and decide what to do. Motives for decision making are inescapably complex. Where a fiduciary also represents the employer, the problem is simply exacerbated. It is exacerbated by the importance of the employer interest to the fiduciary (the fiduciary's livelihood may be involved), its pervasiveness, and the significant chance of divergence of employer and plan interest. The risk is not so much that the fiduciary will take the employer's interest into account at all — that may be inevitable — but that he will treat it as a primary consideration rather than, say, as a tie-breaker between two legitimate choices.

Where a controversial choice by an employer-fiduciary would advance the employer's interest, a literal application of the exclusive benefit rule does appear to mandate resignation of the fiduciary. Sometimes this is appropriate. *See Schwartz v. Interfaith Medical Center*, 715 F.Supp. 1190 (E.D.N.Y. 1989). But courts understandably conclude that such an extreme requirement often constitutes overkill and is not always appropriate. Any workable rule must take into account the nature of decision making and the virtual inevitability of complex motives. The first step is to decide when fiduciary action on mixed motives (whether or not by an employer-fiduciary) should be treated as wrong. On that basis pragmatic standards may be developed for identifying violations.

Plan fiduciaries are required to act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." ERISA § 404(a)(1)(B). This requirement derives from the trust law duty of prudence, another basic obligation of traditional trustees. In the case of *Donovan v.*

Cunningham, 716 F.2d 1455 at pages 1464 and 1465 (Supra) cited exhaustively by both sides, the Court stated:

> "As we have observed before, Section 404 imposes upon fiduciaries a duty of loyalty and a duty of care. *Iron Workers Local No. 272 v. Bowen*, 624 F.2d 1255, 1260 (5th Cir. 1980). The legislative history of ERISA indicates that Congress intended to incorporate in Section 404 the "care principles of fiduciary conduct" that were developed in the common law of trusts, but with modifications appropriate for employee benefit plans. Also, Congress has exhorted those who must interpret and apply ERISA's fiduciary standards to do so "bearing in mind the special nature and purpose of employee benefit plans." H.R. Rep. No. 1280, 174 U.S. Code Cong. & Ad. News at 5083. *See Marshall v. Glass/Metal Assn. & Glaziers & Glassworkers Pension Plan*, 507 F.Supp. 378, 383 (D.Ha. 1980). ("(Section 1104) establishes uniform federal requirements to be interpreted both in the light of the common law of trusts, as well as with a view toward the special nature, purpose, and importance of modern employee benefit plans.").
>
> "As a supplement to the general duties imposed on fiduciaries by Section 404, ERISA also incorporates a detailed list of specifically prohibited transactions. These prohibited transaction rules are an important part of Congress's effort to tailor traditional judge made trust law to fit the activities of fiduciaries functioning in the special context of employee benefit plans. The object of Section 406 was to make illegal per se the types of transactions

> that experience had shown to entail a high potential for abuse. *Cutaiar v. Marshal*, 509 F.2d 523, 529 (3rd Cir. 1979); *Marshall v. Kelly*, 465 F.Supp. 341, 354 (W.D.Ok. 1978); *see also Iron Workers v. Bowen*, 624 F.2d at 1261. In the complex setting of employee benefit plans, brightline rules are advantageous to beneficiaries and fiduciaries alike, providing assured protection to the former and clear notice of responsibility to the latter."
>
> "Unfortunately, the present case is not easily solved by the application of bright-line rules . . ."
>
> "These per se rules are not automatically applicable to ESOP fiduciaries, however. Doubtlessly recognizing that such absolute prohibitions would significantly hamper the implementation of ESOPs, particularly by small companies, Congress enacted in Section 408 a conditional exemption from the prohibited transaction rules for acquisition of employer securities by ESOPs and certain other plans. 29 U.S.C. § 1108(e) (1976). An ESOP may acquire employer securities in circumstances that would otherwise violate Section 406 if the purchase is made for 'adequate consideration.' "

Utilizng the rationale in the *Donovan v. Cunningham* case (supra), it would appear that Section 408 also provides a conditional exemption from the prohibited transaction rules for the disposition of ESOP securities to a related party of the employer.

The standard of prudence is objective, *Katsaros v. Cody*, 744 F.2d (2nd Cir. 1984), and it applies mainly to deliberative conduct such as investment decisions,

employment decisions, and delegations of responsibility. The standard is generally understood as that of a prudent expert. It may also require a fiduciary to obtain expert advice, *id.*, and heed it when given, *Brock v. Self*, 632 F.Supp. 1509 (W.D.La. 1986). The duty is mainly procedural; the chief consideration is the steps taken before acting. "A court's task is to inquire whether the trustees, at the time they engaged in the challenged transaction, employed the appropriate methods . . . The analysis considers the trustees' conduct and not . . . success or failure." *Donovan v. Walton*, 609 F.Supp. 1221 (D.C.Fla. 1985), *aff'd* sub. nom. *Brock v. Walton*, 794 F.2d 586 (11th Cir. 1986).

DOL regulations have provided some clarifications for the duty. A fiduciary who has appointed other fiduciaries has an obligation periodically to monitor their performance. 29 C.F.R. § 2509.75-8, at FR-17. A fiduciary may rely on information from and work of nonfiduciaries who perform services for the plan, provided they have exercised prudence in their selection and retention (i.e., if in the exercise of ordinary care he has no reason to doubt their competence, integrity or responsibility). 29 C.F.R. § 2509.75, at FR-11.

In the instant case, the evidence is clear and convincing that the continued liquidity of the PAE ESOP was the prime reason the plan fiduciaries voted to sell the PAE ESOP stock to the E. & A. Shay Irrevocable Trust on November 9, 1988. Mr. Ronald Ludwig, counsel for the PAE ESOP, testified that there was a continuing problem of PAE to provide liquid funds to the PAE ESOP to purchase shares from the plan beneficiaries. The problem, simply stated, was how to pay off the plan beneficiaries. It was Mr. Ludwig at meetings in October 1987 and May 1988 that suggested an independent valuation and fairness opinion be provided so that the PAE ESOP committee members would comply with their

ERISA imposed fiduciary duties. In addition, Mr. Ludwig also testified that discussions were held as to who would provide the liquidity to terminate the PAE ESOP, i.e., E. Shay, an entity controlled by E. Shay or PAE.

Although, in this Court's opinion it probably would have been more prudent, in hindsight, to retain independent or neutral fiduciaries for purposes of the sale of the PAE ESOP stock to the E. & A. Shay Irrevocable Trust, it is not fatal here. Mr. Ludwig testified that during the period 1986 to 1988 he (Ludwig) never suggested that independent or neutral fiduciaries should be appointed. Mr. Ludwig did testify, however, that when the specific buyer for the PAE ESOP transaction became known that he did suggest to Mr. Daniel Fogel, corporate counsel for PAE, that the appointment of independent or neutral fiduciaries be considered. This suggestion was discussed and rejected in that the international public accounting firm of Arthur Young & Company had been retained to render an independent valuation of the PAE ESOP stock and a fairness opinion of the transaction in question.

Defendants Richard L. Smith and Martin L. Lehrer, the two fiduciaries and members of the PAE ESOP committee, who voted to sell the ESOP shares for $14.40 per share, based upon the Arthur Young & Company valuation, testified that they knew the evaluation was going to be used to sell all of the PAE owned ESOP stock to an entity controlled by the majority shareholder, Edward Shay, not a third party. Mr. Edward Shay was present at the vote, but intentionally abstained from voting to sell the shares.

This Court has reviewed the anatomy of the entire PAE ESOP transaction and finds that the PAE ESOP fiduciary committee did not breach their fiduciary duties in selling the ESOP owned PAE stock to the E. & A.

Shay Irrevocable Trust for $14.40 per share as of November 9, 1988. The marketability prediscount ceiling on the PAE ESOP stock was $28.80 per share. The post-marketability discount floor for the PAE ESOP stock was $14.40 per share. Utilizing the "business judgment" rule, this Court cannot find that the PAE ESOP committee breached any fiduciary duty in relying on the Arthur Young & Company independent valuation and fairness opinion in completing the transaction in question at the $14.40 per share price rather than at some point between $14.40 or $28.80. To do otherwise would be too speculative and would place the Court in the inevitable position of remaking and renegotiating the transaction. This Court specifically finds that the per share price of $14.40 received for the PAE ESOP shares by the plan participants on November 9, 1988, was full, fair and adequate consideration. In *Donovan v. Cunningham*, 716 F.2d 1455 at 1474, the court stated that:

> "An independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled. It is a tool and, like all tools, is useful only if used properly. To use an independent appraisal properly, ERISA fiduciaries need not become experts in the valuation of closely held stock — they are entitled to rely on the expertise of others. See note 26, supra. However, as the source of information upon which the experts' opinions are based, the fiduciaries are responsible for ensuring that the information is complete and up-to-date."

Here, in the instant case, this Court has previously found that the fiduciaries provided Arthur Young & Company with extensive documentation regarding PAE's operations. (See footnote 2, supra). Therefore,

the PAE ESOP fiduciaries did not breach their duties of prudence under Section 404 in their reliance upon the Arthur Young & Company valuation report and fairness opinion and their decision to sell the PAE ESOP stock to the E. & A. Shay Irrevocable Trust for $14.40 per share.

VI.

CONCLUSON

Accordingly, this Court finds for the defendants on all causes of action.

Each party to bear their own costs and attorneys' fees.

Counsel for defendants to prepare proposed "Findings of Fact" and "Conclusions of Law" in accordance with this ruling.

Counsel for defendants to prepare a proposed "Judgment" in accordance with this ruling.

DATED: September 14, 1993

/s/ DICKRAN TEVRIZIAN
DICKRAN TEVRIZIAN
United States District Judge

I hereby certify that this document was served by First Class mail, postage prepaid, to all counsel (or parties) at their respective most recent address of record in this action on this date.

SEP 15 1993
DATED

/s/ Menna Neumaier
DEPUTY CLERK

APPENDIX F

Larry R. Feldman
Lester G. Ostrov
Gerald J. Miller
FOGEL, FELDMAN, OSTROV, RINGLER & KLEVENS
A Law Corporation
1620 - 26th Street, Suite 100 South
Santa Monica, CA 90404-4040
(310) 453-6711
Attorneys for Defendants

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

FILED
OCT 1, 1993
Clerk, U.S. District Court
Central District of California
By Deputy

NEWMAN HOWARD, GILBERT LEON ALLEN, JOAN HOWARD, and THEODORE H. POPE as representatives of plan participants similarly situated on behalf of THE EMPLOYEE STOCK OWNERSHIP PLAN OF PACIFIC ARCHITECTS AND ENGINEERS INCORPORATED,

Plaintiffs,

vs.

EDWARD A. SHAY, MARTIN L. LEHRER, RICHARD L. SMITH, ALLEN SHAY, and PACIFIC ARCHITECTS AND ENGINEERS INCORPORATED,

Defendants.

CASE NO. CV-91 0146DT (GHKx)

THIS CONSTITUTES NOTICE OF ENTRY
AS REQUIRED BY FRCP, RULE 77(d).

CLASS ACTION
JUDGMENT
[Fed. R. Civ. P. Rule 58]

This action came on for trial before the Court, Honorable Dickran Tevrizian, Jr., District Judge, presiding, and the issues having been duly tried and a Memorandum of Decision having been filed,

It is Ordered and Adjudged that the plaintiffs take nothing, that the action be dismissed on the merits, and that each party bear their own costs and attorneys' fees.

Dated at Los Angeles, California, this 1 day of OCT 1993.

DICKRAN TEVRIZIAN
DICKRAN TEVRIZIAN

APPENDIX G

REVENUE RULING 59-60

SECTION 2031. - DEFINITION OF GROSS ESTATE

26 CFR 20.2031-2: Valuation of stocks and bonds.

(Also Section 2512.)
(Also Part II, Sections 811(k), 1005, Regulations 105, Section 81.10.)

In valuing the stock of closely held corporations, or the stock of corporations where market quotations are not available, all other available financial data, as well as all relevant factors affecting the fair market value must be considered for estate tax and gift tax purposes. No general formula may be given that is applicable to the many different valuation situations arising in the valuation of such stock. However, the general approach, methods, and factors which must be considered in valuing such securities are outlined.

Revenue Ruling 54-77, C.B. 1954-1, 187, superseded.

SECTION 1. PURPOSE.

The purpose of this Revenue Ruling is to outline and review in general the approach, methods and factors to be considered in valuing shares of the capital stock of closely held corporations for estate tax and gift tax purposes. The methods discussed herein will apply likewise to the valuation of corporate stocks on which market quotations are either unavailable or are of such scarcity that they do not reflect the fair market value.

SEC. 2. BACKGROUND AND DEFINITIONS.

.01 All valuations must be made in accordance with the applicable provisions of the Internal Revenue Code

of 1954 and the Federal Estate Tax and Gift Tax Regulations. Sections 2031(a), 2032 and 2512(a) of the 1954 Code (sections 811 and 1005 of the 1939 Code) require that the property to be included in the gross estate, or made the subject of a gift, shall be taxed on the basis of the value of the property at the time of death of the decedent, the alternate date if so elected, or the date of gift.

.02 Section 20.2031-1(b) of the Estate Tax Regulations (section 81.10 of the Estate Tax Regulations 105) and section 25.2512-1 of the Gift Tax Regulations (section 86.19 of Gift Tax Regulations 108) define fair market value, in effect, as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

.03 Closely held corporations are those corporations the shares of which are owned by a relatively limited number of stockholders. Often the entire stock issue is held by one family. The result of this situation is that little, if any, trading in the shares takes place. There is, therefore, no established market for the stock and such sales as occur at irregular intervals seldom reflect all of the elements of a representative transaction as defined by the term "fair market value."

SEC. 3. APPROACH TO VALUATION.

.01 A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be

generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

.02 The fair market value of specific shares of stock will vary as general economic conditions change from "normal" to "boom" or "depression," that is, according to the degree of optimism or pessimism with which the investing public regards the future at the required date of appraisal. Uncertainty as to the stability or continuity of the future income from a property decreases its value by increasing the risk of loss of earnings and value in the future. The value of shares of stock of a company with very uncertain future prospects is highly speculative. The appraiser must exercise his judgment as to the degree of risk attaching to the business of the corporation which issued the stock, but that judgment must be related to all of the other factors affecting value.

.03 Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal. As a generalization, the prices of stocks which are traded in volume in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporations and industries represented. When a stock is closely held, is traded infrequently, or is traded in an erratic market, some other measure of value must be used. In many instances, the next best measure may be found in the prices at which the stocks of

companies engaged in the same or a similar line of business are selling in a free and open market.

SEC. 4. FACTORS TO CONSIDER.

.01 It is advisable to emphasize that in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following factors, although not all-inclusive are fundamental and require careful analysis in each case:

(a) The nature of the business and the history of the enterprise from its inception.

(b) The economic outlook in general and the condition and outlook of the specific industry in particular.

(c) The book value of the stock and the financial condition of the business.

(d) The earning capacity of the company.

(e) The dividend-paying capacity.

(f) Whether or not the enterprise has goodwill or other intangible value.

(g) Sales of the stock and the size of the block of stock to be valued.

(h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

.02 The following is a brief discussion of each of the foregoing factors:

(a) The history of a corporate enterprise will show its past stability or instability, its growth or lack of growth, the diversity or lack of diversity of its

operations, and other facts needed to form an opinion of the degree of risk involved in the business. For an enterprise which changed its form of organization but carried on the same or closely similar operations of its predecessor, the history of the former enterprise should be considered. The detail to be considered should increase with approach to the required date of appraisal, since recent events are of greatest help in predicting the future; but a study of gross and net income, and of dividends covering a long prior period, is highly desirable. The history to be studied should include, but need not be limited to, the nature of the business, its products or services, its operating and investment assets, capital structure, plant facilities, sales records and management, all of which should be considered as of the date of the appraisal, with due regard for recent significant changes. Events of the past that are unlikely to recur in the future should be discounted, since value has a close relation to future expectancy.

(b) A sound appraisal of a closely held stock must consider current and prospective economic conditions as of the date of appraisal, both in the national economy and in the industry or industries with which the corporation is allied. It is important to know that the company is more or less successful than its competitors in the same industry, or that it is maintaining a stable position with respect to competitors. Equal or even greater significance may attach to the ability of the industry with which the company is allied to compete with other industries. Prospective competition which has not been a factor in prior years should be given careful attention. For example, high profits due to the novelty of its product and the lack of competition often lead to increasing competition. The public's appraisal of the future prospects of competitive industries or of competitors within an industry may be indicated by price trends in

the markets for commodities and for securities. The loss of the manager of a so-called "one-man" business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absence of management-succession potentialities are pertinent factors to be taken into consideration. On the other hand, there may be factors which offset, in whole or in part, the loss of the manager's services. For instance, the nature of the business and of its assets may be such that they will not be impaired by the loss of the manager. Furthermore, the loss may be adequately covered by life insurance, or competent management might be employed on the basis of the consideration paid for the former manager's services. These, or other offsetting factors, if found to exist, should be carefully weighed against the loss of the manager's services in valuing the stock of the enterprise.

(c) Balance sheets should be obtained, preferably in the form of comparative annual statements for two or more years immediately preceding the date of appraisal, together with a balance sheet at the end of the month preceding that date, if corporate accounting will permit. Any balance sheet descriptions that are not self-explanatory, and balance sheet items comprehending diverse assets or liabilities, should be clarified in essential detail by supporting supplemental schedules. These statements usually will disclose to the appraiser (1) liquid position (ratio of current assets to current liabilities); (2) gross and net book value of principal classes of fixed assets; (3) working capital; (4) long-term indebtedness; (5) capital structure; and (6) net worth. Consideration also should be given to any assets

not essential to the operation of the business, such as investments in securities, real estate, etc. In general, such nonoperating assets will command a lower rate of return than do the operating assets, although in exceptional cases the reverse may be true. In computing the book value per share of stock, assets of the investment type should be revalued on the basis of their market price and the book value adjusted accordingly. Comparison of the company's balance sheets over several years may reveal, among other facts, such developments as the acquisition of additional production facilities or subsidiary companies, improvement in financial position, and details as to recapitalizations and other changes in the capital structure of the corporation. If the corporation has more than one class of stock outstanding, the charter or certificate of incorporation should be examined to ascertain the explicit rights and privileges of the various stock issues including: (1) voting powers, (2) preference as to dividends, and (3) preference as to assets in the event of liquidation.

(d) Detailed profit-and-loss statements should be obtained and considered for a representative period immediately prior to the required date of appraisal, preferably five or more years. Such statements should show (1) gross income by principal items; (2) principal deductions from gross income including major prior items of operating expenses, interest and other expense on each item of long-term debt, depreciation and depletion if such deductions are made, officers' salaries, in total if they appear to be reasonable or in detail if they seem to be excessive, contributions (whether or not deductible for tax purposes) that the nature of its business and its community position require the corporation to make, and taxes by principal items, including income and excess profits taxes; (3) net income available for dividends; (4) rates and amounts of dividends paid on

each class of stock; (5) remaining amount carried to surplus; and (6) adjustments to, and reconciliation with, surplus as stated on the balance sheet. With profit and loss statements of this character available, the appraiser should be able to separate recurrent from nonrecurrent items of income and expense, to distinguish between operating income and investment income, and to ascertain whether or not any line of business in which the company is engaged is operated consistently at a loss and might be abandoned with benefit to the company. The percentage of earnings retained for business expansion should be noted when dividend-paying capacity is considered. Potential future income is a major factor in many valuations of closely-held stocks, and all information concerning past income which will be helpful in predicting the future should be secured. Prior earnings records usually are the most reliable guide as to the future expectancy, but resort to arbitrary five-or-ten-year averages without regard to current trends or future prospects will not produce a realistic valuation. If, for instance, a record of progressively increasing or decreasing net income is found, then greater weight may be accorded the most recent years' profits in estimating earning power. It will be helpful, in judging risk and the extent to which a business is a marginal operator, to consider deductions from income and net income in terms of percentage of sales. Major categories of cost and expense to be so analyzed include the consumption of raw materials and supplies in the case of manufacturers, processors and fabricators; the cost of purchased merchandise in the case of merchants; utility services; insurance; taxes; depletion or depreciation; and interest.

(e) Primary consideration should be given to the dividend-paying capacity of the company rather than to dividends actually paid in the past. Recognition must be given to the necessity of retaining a reasonable portion

of profits in a company to meet competition. Dividend-paying capacity is a factor that must be considered in an appraisal, but dividends actually paid in the past may not have any relation to dividend-paying capacity. Specifically, the dividends paid by a closely held family company may be measured by the income needs of the stockholders or by their desire to avoid taxes on dividend receipts, instead of by the ability of the company to pay dividends. Where an actual or effective controlling interest in a corporation is to be valued, the dividend factor is not a material element, since the payment of such dividends is discretionary with the controlling stockholders. The individual or group in control can substitute salaries and bonuses for dividends, thus reducing net income and understating the dividend-paying capacity of the company. It follows, therefore, that dividends are less reliable criteria of fair market value than other applicable factors.

(f) In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.

(g) Sales of stock of a closely held corporation should be carefully investigated to determine whether they represent transactions at arm's length. Forced or distress sales do not ordinarily reflect fair market value nor do isolated sales in small amounts necessarily control as the measure of value. This is especially true in the valuation of a controlling interest in a corporation. Since, in the case of closely held stocks, no prevailing market prices are available, there is no basis for making an adjustment for blockage. It follows, therefore, that such stocks should be valued upon a consideration of all the evidence affecting the fair market value. The size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.

(h) Section 2031(b) of the Code states, in effect, that in valuing unlisted securities the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange should be taken into consideration along with all other factors An important consideration is that the corporations to be used for comparisons have capital stocks which are actively traded by the public. In accordance with section 2031(b) of the Code, stocks listed on an exchange are to be considered first. However, if sufficient comparable companies whose stocks are listed on an exchange cannot be found, other comparable companies which have stocks actively traded in on the over-the-counter market also may be used. The essential factor is that whether the stocks are sold on an exchange or over-the-counter there is evidence of an active, free public market for the stock as of the valuation date. In

selecting corporations for comparative purposes, care should be taken to use only comparable companies. Although the only restrictive requirement as to comparable corporations specified in the statute is that their lines of business be the same or similar, yet it is obvious that consideration must be given to other relevant factors in order that the most valid comparison possible will be obtained. For illustration, a corporation having one or more issues of preferred stock, bonds or debentures in addition to its common stock should not be considered to be directly comparable to one having only common stock outstanding. In like manner, a company with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion.

SEC. 5. WEIGHT TO BE ACCORDED VARIOUS FACTORS.

The valuation of closely held corporate stock entails the consideration of all relevant factors as stated in section 4. Depending upon the circumstances in each case, certain factors may carry more weight than others because of the nature of the company's business. To illustrate:

(a) Earnings may be the most important criterion of value in some cases whereas asset value will receive primary consideration in others. In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.

(b) The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets

underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.

SEC. 6. CAPITALIZATION RATES.

In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation. That there is no ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling prices of corporate shares listed on the major exchanges of the country. Wide variations will be found even for companies in the same industry. Moreover, the ratio will fluctuate from year to year depending upon economic conditions. Thus, no standard tables of capitalization rates applicable to closely held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitaliza-

tion rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings.

SEC. 7. AVERAGE OF FACTORS.

Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (for example, book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance.

SEC. 8. RESTRICTIVE AGREEMENTS.

Frequently, in the valuation of closely held stock for estate and gift tax purposes, it will be found that the stock is subject to an agreement restricting its sale or transfer. Where shares of stock were acquired by a decedent subject to an option reserved by the issuing corporation to repurchase at a certain price, the option price is usually accepted as the fair market value for estate tax purposes. See Rev. Rul. 54-76 C.B. 1954-1, 194. However, in such case the option price is not determinative of fair market value for gift tax purposes. Where the option, or buy and sell agreement, is the result of voluntary action by the stockholders and is binding during the life as well as at the death of the stockholders, such agreement may or may not, depending upon the circumstances of each case, fix the value for estate tax purposes. However, such agreement is a factor to be considered, with other relevant factors, in

determining fair market value. Where the stockholder is free to dispose of his shares during life and the option is to become effective only upon his death, the fair market value is not limited to the option price. It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a bonafide business arrangement or is a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. In this connection see Rev. Rul. 157 C.B. 1953-2, 255, and Rev Rul. 189, C.B. 1953-2, 294.

SEC. 9. EFFECT ON OTHER DOCUMENTS.

Revenue Ruling 54-77, C.B. 1954-1, 187, is hereby superseded.

APPENDIX H

CODE OF FEDERAL REGULATIONS
26 CFR § 20.2031-1

§ 20.2031-1 Definition of gross estate; valuation of property.

(a) Definition of gross estate. Except as otherwise provided in this paragraph the value of the gross estate of a decedent who was a citizen or resident of the United States at the time of his death is the total value of the interests described in sections 2033 through 2044. The gross estate of a decedent who died before October 17, 1962, does not include real property situated outside the United States (as defined in paragraph (b) (1) of § 20.0-1). Except as provided in paragraph (c) of this section (relating to the estates of decedents dying after October 16, 1962, and before July 1, 1964), in the case of a decedent dying after October 16, 1962, real property situated outside the United States which comes within the scope of sections 2033 through 2044 is included in the gross estate to the same extent as any other property coming within the scope of those sections. In arriving at the value of the gross estate the interests described in sections 2033 through 2044 are valued as described in this section, §§ 20.2031-2 through 20.2031-9 and § 20.2032-1. The contents of sections 2033 through 2044 are, in general, as follows:

(1) Sections 2033 and 2034 are concerned mainly with interests in property passing through the decedent's probate estate. Section 2033 includes in the decedent's gross estate any interest that the decedent had in property at the time of his death. Section 2034 provides that any interest of the decedent's surviving spouse in the decedent's property, such as dower or curtesy, does not prevent the inclusion of such property in the decedent's gross estate.

(2) Sections 2035 through 2038 deal with interests in property transferred by the decedent during his life under such circumstances as to bring the interests within the decedent's gross estate. Section 2035 includes in the decedent's gross estate property transferred in contemplation of death, even though the decedent had not interest in, or control over, the property at the time of his death. Section 2036 provides for the inclusion of transferred property with respect to which the decedent retained the income or the power to designate who shall enjoy the income. Section 2037 includes in the decedent's gross estate certain transfers under which the beneficial enjoyment of the property could be obtained only by surviving the decedent. Section 2038 provides for the inclusion of transferred property if the decedent had at the time of his death the power to change the beneficial enjoyment of the property. It should be noted that there is considerable overlap in the application of sections 2036 through 2038 with respect to reserved powers, so that transferred property may be includible in the decedent's gross estate in varying degrees under more than one of those sections.

(3) Sections 2039 through 2042 deal with special kinds of property and powers. Sections 2039 and 2040 concern annuities and jointly held property respectively. Section 2041 deals with powers held by the decedent over the beneficial enjoyment of property not originating with the decedent. Section 2042 concerns insurance under policies on the life of the decedent.

(4) Section 2043 concerns the sufficiency of consideration for transfers made by the decedent during his life. This has a bearing on the amount to be included in the decedent's gross estate under sections 2035 through 2038, and 2041. Section 2044 deals with retroactivity.

(b) Valuation of property in general. The value of every item of property includible in a decedent's gross

estate under sections 2031 through 2044 is its fair market value at the time of the decedent's death, except that if the executor elects the alternate valuation method under section 2032, it is the fair market value thereof at the date, and with the adjustments, prescribed in that section. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property includible in the decedent's gross estate, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail. For example, the fair market value of an automobile (an article generally obtained by the public in the retail market) includible in the decedent's gross estate is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public and not the price for which the particular automobile of the decedent would be purchased by a dealer in used automobiles. Examples of items of property which are generally sold to the public at retail may be found in §§ 20.2031-6 and 20.2031-8. The value is generally to be determined by ascertaining as a basis the fair market value as of the applicable valuation date of each unit of property. For example, in the case of shares of stock or bonds, such unit of property is generally a share of stock or a bond. Livestock, farm

machinery, harvested and growing crops must generally be itemized and the value of each item separately returned. Property shall not be returned at the value at which it is assessed for local tax purposes unless that value represents the fair market value as of the applicable valuation date. All relevant facts and elements of value as of the applicable valuation date shall be considered in every case. The value of items of property which were held by the decedent for sale in the course of a business generally should be reflected in the value of the business. For valuation of interests in businesses, see § 20.2031-3. See § 20.2031-2 and §§ 20.2031-4 through 20.2031-8 for further information concerning the valuation of other particular kinds of property. For certain circumstances under which the sale of an item of property at a price below its fair market value may result in a deduction for the estate, see paragraph (d) (2) of § 20.2053-3.

(c) Real property situated outside the United States; gross estate of decedent dying after October 16, 1962, and before July 1, 1964 —

(1) In general. In the case of decedent dying after October 16, 1962, and before July 1, 1964, the value of real property situated outside the United States (as defined in paragraph (b) (1) of § 20.0-1) is not included in the gross estate of the decedent —

(i) Under section 2033, 2034, 2035(a), 2036(a), 2037(a), or 2038(a) to the extent the real property, or the decedent's interest in it, was acquired by the decedent before February 1, 1962;

(ii) Under section 2040 to the extent such property or interest was acquired by the decedent before February 1, 1962, or was held by the decedent and the survivor in a joint tenancy or tenancy by the entirety before February 1, 1962; or

(iii) Under section 2041(a) to the extent that before February 1, 1962, such property or interest was subject to a general power of appointment (as defined in section 2041) possessed by the decedent.

(2) Certain property treated as acquired before February 1, 1962. For purposes of this paragraph real property situated outside the United States (including property held by the decedent and the survivor in a joint tenancy or tenancy by the entirety), or an interest in such property or a general power of appointment in respect of such property, which was acquired by the decedent after January 31, 1962, is treated as acquired by the decedent before February 1, 1962, if

(i) Such property, interest, or power was acquired by the decedent by gift within the meaning of section 2511, or from a prior decedent by devise or inheritance, or by reason of death, form of ownership, or other conditions (including the exercise or nonexercise of a power of appointment); and

(ii) Before February 1, 1962, the donor or prior decedent had acquired the property or his interest therein or had possessed a power of appointment in respect thereof.

(3) Certain property treated as acquired after January 31, 1962. For purposes of this paragraph that portion of capital additions or improvements made after January 31, 1962, to real property situated outside the United States is, to the extent that it materially increases the value of the property, treated as real property acquired after January 31, 1962. Accordingly, the gross estate may include the value of improvements on unimproved real property, such as office buildings, factories, houses, fences, drainage ditches, and other capital items, and the value of capital additions and improvements to existing improvements, placed on real property after January 31, 1962, whether or not the value

of such real property or existing improvements is included in the gross estate.

HISTORY:
[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 6684, 28 FR 11408, Oct. 24, 1963; T.D. 6826, 30 FR 7708, June 15, 1965]

AUTHORITY:
Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805.

NOTES:
EDITORIAL NOTE: IRS published a document at 45 FR 6088, Jan. 25, 1980, deleting statutory sections from their regulations. In Chapter I cross references to the deleted material have been changed to the corresponding sections of the IRS Code of 1954 or to the appropriate regulations sections. When either such change produced a redundancy, the cross-reference has been deleted. For further explanation, see 45 FR 20795, Mar. 31, 1980.

[The OMB control numbers for title 26 appear in §§ 601.9000 and 602.101 of this chapter.]

APPENDIX I

DEPARTMENT OF LABOR

Pension and Welfare Benefits Administration

29 CFR Part 2510

Proposed Regulation Relating to the Definition of Adequate Consideration

AGENCY: Pension and Welfare Benefits Administration, Department of Labor.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains a notice of a proposed regulation under the Employee Retirement Income Security Act of 1974 (the Act or ERISA) and the Federal Employees' Retirement System Act of 1986 (FERSA). The proposal clarifies the definition of the term "adequate consideration" provided in section 3(18)(B) of the Act and section 8477(a)(2)(B) of FERSA for assets other than securities for which there is a generally recognized market. Section 3(18)(B) and section 8477(a)(2)(B) provide that the term "adequate consideration" for such assets means the fair market value of the asset as determined in good faith by the trustee or named fiduciary (or, in the case of FERSA, a fiduciary) pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary of Labor. Because valuation questions of this nature arise in a variety of contexts, the Department is proposing this regulation in order to provide the certainty necessary for plan fiduciaries to fulfill their statutory duties. If adopted, the regulation would affect plans investing in assets other than securities for which there is a generally recognized market.

DATES: Written comments on the proposed regulation must be received by July 18, 1988. If adopted, the regulation will be effective for transactions taking place after the date 30 days following publication of the regulation in final form.

ADDRESS: Written comments on the proposed regulation (preferably three copies) should be submitted to: Office of Regulations and Interpretations, Pension and Welfare Benefits Administration, Room N-5671, U.S. Department of Labor, 200 Constitution Avenue NW., Washington, DC 20216, Attention: Adequate Consideration Proposal. All written comments will be available for public inspection at the Public Disclosure Room, Pension and Welfare Benefits Administration, U.S. Department of Labor, Room N-5507, 200 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT:
Daniel J. Maguire, Esq., Plan Benefits Security Division, Office of the Solicitor, U.S. Department of Labor, Washington, DC 20210, (202) 523-9596 (not a toll-free number) or Mark A. Greenstein, Office of Regulations and Interpretations, Pension and Welfare Benefits Administration, (202) 523-7901 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

A. Background

Notice is hereby given of a proposed regulation under section 3(18)(B) of the Act and section 8477(a)(2)(B) of FERSA. Section 3(18) of the Act provides the definition for the term "adequate consideration," and states:

The term "adequate consideration" when used in part 4 of subtitle B means (A) in the case of a security for

which there is a generally recognized market, either (i) the price of the security prevailing on a national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934, or (ii) if the security is not traded on such a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of any party interest; and (B) in the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary.

The term "adequate consideration" appears four times in part 4 of subtitle B of Title I of the Act, and each time represents a central requirement for a statutory exemption from the prohibited transaction restrictions of the Act. Under section 408(b)(5), a plan may purchase insurance contracts from certain parties in interest if, among other conditions, the plan pays no more than adequate consideration. Section 408(b)(7) provides that the prohibited transaction provisions of section 406 shall not apply to the exercise of a privilege to convert securities, to the extent provided in regulations of the Secretary of Labor, only if the plan receives no less than adequate consideration pursuant to such conversion. Section 408(e) of the Act provides that the prohibitions in sections 406 and 407(a) of the Act shall not apply to the acquisition or sale by a plan of qualifying employer securities, or the acquisition, sale or lease by a plan of qualifying employer real property if, among other conditions, the acquisition, sale or lease is for adequate consideration. Section 414(c)(5) of the Act states that sections 406 and 407(a) of the Act shall not apply to the

sale, exchange, or other disposition of property which is owned by a plan on June 30, 1974, and all times thereafter, to a party in interest, if such plan is required to dispose of the property in order to comply with the provisions of section 407(a) (relating to the prohibition against holding excess employer securities and employer real property), and if the plan receives not less than adequate consideration.

Public utilization of these statutory exemptions requires a determination of "adequate consideration" in accordance with the definition contained in section 3(18) of the Act. Guidance is especially important in this area because many of the transactions covered by these statutory exemptions involve plan dealings with the plan sponsor. A fiduciary's determination of the adequacy of consideration paid under such circumstances represents a major safeguard for plans against the potential for abuse inherent in such transactions.

The Federal Employees' Retirement System Act of 1986 (FERSA) established the Federal Retirement Thrift Investment Board whose members act as fiduciaries with regard to the assets of the Thrift Savings Fund. In general, FERSA contains fiduciary obligation and prohibited transaction provisions similar to ERISA. However, unlike ERISA, FERSA prohibits party in interest transactions similar to those described in section 406(a) of ERISA only in those circumstances where adequate consideration is not exchanged between the Fund and the party in interest. Specifically, section 8477(c)(1) of FERSA provides that, except in exchange for adequate consideration, a fiduciary shall not permit the Thrift Savings Fund to engage in: transfers of its assets to, acquisition of property from or sales of property to, or transfers or exchanges of services with any person the fiduciary knows or should know to be a party in interest. Section 8477(a)(2) provides the FERSA

definition for the term "adequate consideration" which is virtually identical to that contained in section 3(18) of ERISA. Thus, the proposal would apply to both section 3(18) of ERISA and section 8477(a)(2) of FERSA.

When the asset being valued is a security for which there is a generally recognized market, the plan fiduciary must determine "adequate consideration" by reference to the provisions of section 3(18)(A) of the Act (or with regard to FERSA, section 8477(a)(2)(A)). Section 3(18)(A) and section 8477(a)(2)(A) provide detailed reference points for the valuation of securities within its coverage, and in effect provides that adequate consideration for such securities is the prevailing market price. It is not the Department's intention to analyze the requirements of section 3(18)(A) or 8477(a)(2)(A) in this proposal. Fiduciaries must, however, determine whether a security is subject to the specific provisions of section 3(18)(A) (or section 8477(a)(2)(A) of FERSA) or the more general requirements of section 3(18)(B) (or section 8477(a)(2)(B)) as interpreted in this proposal. The question of whether a security is one for which there is a generally recognized market requires a factual determination in light of the character of the security and the nature and extent of market activity with regard to the security. Generally, the Department will examine whether a security is being actively traded so as to provide the benchmarks Congress intended. Isolated trading activity, or trades between related parties, generally will not be sufficient to show the existence of a generally recognized market for the purposes of section 3(18) (A) or section 8477(a)(2)(A).

In the case of all assets other than securities for which there is a generally recognized market, fiduciaries must determine adequate consideration pursuant to section 3(18)(B) of the Act (or, in the case of FERSA, section 8477(a)(2)(B)). Because it is designed to deal with all

but a narrow class of assets, section 3(18)(B) and section 8477(a)(2)(B) are by their nature more general than section 3(18)(A) or section 8477(a)(2)(A). Although the Department has indicated that it will not issue advisory opinions stating whether certain stated consideration is "adequate consideration" for the purposes of section 3(18), ERISA Procedure 76-1, § 5.02(a) (41 FR 36281, 36282, August 27, 1976), the Department recognizes that plan fiduciaries have a need for guidance in valuing assets, and that standards to guide fiduciaries in this area may be particularly elusive with respect to assets other than securities for which there is a generally recognized market. *See*, for example, *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983) (court encourages the Department to adopt regulations under section 3(18)(B)). The Department has therefore determined to propose a regulation only under section 3(18)(B) and section 8477(a)(2)(B). This proposal is described more fully below.

It should be noted that it is not the Department's intention by this proposed regulation to relieve fiduciaries of the responsibility for making the required determinations of "adequate consideration" where applicable under the Act or FERSA. Nothing in the proposal should be construed as justifying a fiduciary's failure to take into account all relevant facts and circumstances in determining adequate consideration. Rather, the proposal is designed to provide a framework within which fiduciaries can fulfill their statutory duties. Further, fiduciaries should be aware that, even where a determination of adequate consideration comports with the requirements of section 3(18)(B) (or section 8477(a)(2)(B) of FERSA) and any regulation adopted thereunder, the investment of plan assets made pursuant to such determination will still be subject to the fiduciary requirements of Part 4 of Subtitle B of Title I

of the Act, including the provisions a sections 403 and 404 of the Act, or the fiduciary responsibility provisions of FERSA.

B. Description of the Proposal

Proposed regulation 29 CFR 2510.3-18(b) is divided into four major parts. Proposed § 2510.3-18(b)(l) states the general rule and delineates the scope of the regulation. Proposed § 2510.3-18(b)(2) addresses the concept of fair market value as it relates to a determination of "adequate consideration" under section 3(18)(B) of the Act. Proposed § 2510.3-18(b)(3) deals with the requirement in section 3(18)(B) that valuing fiduciary act in good faith, and specifically discusses the use of an independent appraisal in connection with the determination of good faith. Proposed § 2510.3-18(b)(4) sets forth the content requirements for written valuations used as the basis for a determination of fair market value, with a special rule for the valuation of securities other than securities for which there is a generally recognized market. Each subsection is discussed in detail below.

1. General Rule and Scope.

Proposed § 2510.3-18(b)(1)(i) essentially follows the language of section 3(18)(B) of the Act and section 8477(a)(2)(B) of FERSA and states that, in the case of a plan asset other than a security for which there is a generally recognized market, the term "adequate consideration" means the fair market value of the asset as determined in good faith by the trustee or named fiduciary (or, in the case of FERSA, a fiduciary) pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary of Labor. Proposed § 2510.3-18(b)(1)(ii) delineates the scope of

this regulation by establishing two criteria, both of which must be met for a valid determination of adequate consideration. First, the value assigned to an asset must reflect its fair market value as determined pursuant to proposed § 2510.3-18(b)(2). Second, the value assigned to an asset must be the product of a determination made by the fiduciary in good faith as defined in proposed § 2510.3-18(b)(3). The Department will consider that a fiduciary has determined adequate consideration in accordance with section 3(18)(B) of the Act or section 8477(a)(2)(B) of FERSA only if both of these requirements are satisfied.

The Department has proposed this two part test for several reasons. First, Congress incorporated the concept of fair market value into the definition of adequate consideration. As explained more fully below, fair market value is an often used concept having an established meaning in the field of asset valuation. By reference to this term, it would appear that Congress did not intend to allow parties to a transaction to set an arbitrary value for the assets involved. Therefore, a valuation determination which fails to reflect the market forces embodied in the concept of fair market value would also fail to meet the requirements of section 3(18)(B) of the Act or section 8477(a)(2)(B)of FERSA.

Second, it would appear that Congress intended to allow a fiduciary a limited degree of latitude so long as that fiduciary acted in good faith. However, a fiduciary would clearly fail to fulfill the fiduciary duties delineated in Part 4 of Subtitle B of Title I of the Act if that fiduciary acted solely on the basis of naive or uninformed good intentions. *See Donovan v. Cunningham, supra*, 716 F.2d at 1467 ("[A] pure heart and an empty head are not enough.") The Department has therefore proposed standards for a determination of a fiduciary's good faith which must be satisfied in order to

meet the requirements of section 3(18)(B) or section 8477(a)(2)(B) of FERSA.

Third, even if a fiduciary were to meet the good faith standards contained in this proposed regulation, there may be circumstances in which good faith alone fails to insure an equitable result. For example, errors in calculation or honest failure to consider certain information could produce valuation figures outside of the range of acceptable valuations of a given asset. Because the determination of adequate consideration is a central requirement of the statutory exemptions discussed above, the Department believes it must assure that such exemptions are made available only for those transactions possessing all the external safeguards envisioned by Congress. To achieve this end, the Department's proposed regulation links the fair market value and good faith requirements to assure that the resulting valuation reflects market considerations and is the product of a valuation process conducted in good faith.

2. Fair Market Value

The first part of the Department's proposed two part test under section 3(18)(B) and section 8477(a)(2)(B) requires that a determination of adequate consideration reflect the asset's fair market value. The term "fair market value" is defined in proposed § 2510.3-18(b)(2)(i) as the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well-informed about the asset and the market for that asset. This proposed definition essentially reflects the well-established meaning of this term in the area of asset valuation. *See*, for example, 26 CFR 20.2031-1 (estate

tax regulations); Rev. Rul. 59-60, 1959-1 Cum. Bull. 237; *United States v. Cartwright*, 411 U.S. 546, 551 (1973); *Estate of Bright v. United States*, 658 F.2d 999, 1005 (5th Cir. 1981). It should specifically be noted that comparable valuations reflecting transactions resulting from other than free and equal negotiations (*e.g.*, a distress sale) will fail to establish fair market value. *See Hooker Industries, Inc. v. Commissioner*, 3 EBC 1849, 1854-55 (T.C. June 24, 1982). Similarly, the extent to which the Department will view a valuation as reflecting fair market value will be affected by an assessment of the level of expertise demonstrated by the parties making the valuation. *See Donovan v. Cunningham, supra*, 716 F.2d at 1468 (failure to apply solid business principles of evaluation, for whatever reason, may result in a valuation that does not reflect fair market value).[1]

The Department is aware that the fair market value of an asset will ordinarily be identified by a range of valuations rather than a specific, set figure. It is not the Department's intention that only one valuation figure will be acceptable as the fair market value of a specified

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[1] Whether in any particular transaction a plan fiduciary is in fact well-informed about the asset in question and the market for that asset, including any specific circumstances which may affect the value of the asset, will be determined on a facts and circumstances basis. If, however, the fiduciary negotiating on behalf of the plan has or should have specific knowledge concerning either the particular asset or the market for that asset, it is the view of the Department that the fiduciary must take into account that specific knowledge in negotiating the price of the asset in order to meet the fair market value standard of this regulation. For example, a sale of plan-owned real estate at a negotiated price consistent with valuations of comparable property will not be a sale for adequate consideration if the negotiating fiduciary does not take into account any special knowledge which he has or should have about the asset or its market, *e.g.*, that the property's value should reflect a premium due to a certain developer's specific land development plans.

asset. Rather, this proposal would require that the valuation assigned to an asset must reflect a figure within an acceptable range of valuations for that asset.

In addition to this general formulation of the definition of fair market value, the Department is proposing two specific requirements for the determination of fair market value for the purposes of section 3(18)(B) and section 8477(a)(2)(B). First, proposed § 2510.3-18(b)(2)(ii) requires that fair market value must be determined as of the date of the transaction involving that asset. This requirement is designed to prevent situations such as arose in *Donovan v. Cunningham, supra.* In that case, the plan fiduciaries relied on a 1975 appraisal to set the value of employer securities purchased by an ESOP during 1976 and thereafter, and failed to take into account significant changes in the company's business condition in the interim. The court found that this reliance was unwarranted, and therefore the fiduciaries' valuation failed to reflect adequate consideration under section 3(18)(B). *Id.* at 1468-69.

Second, proposed § 2510.3-18(b)(2)(iii) states that the determination of fair market value must be reflected in written documentation of valuation[2] meeting the content requirements set forth in § 2510.3-18(b)(4). (The valuation content requirements are discussed below.) The Department has proposed this requirement in light of the role the adequate consideration requirement plays

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[2] It should be noted that the written valuation required by this section of the proposal need not be a written report of an independent appraiser. Rather, it should be documentation sufficient to allow the Department to determine whether the content requirements of § 2510.3-18(b)(4) have been satisfied. The use of an independent appraiser may be relevant to a determination of good faith, as discussed with regard to proposed § 2510.3-18(b)(3), *infra*, but it is not required to satisfy the fair market value criterion in § 2510.3-18(b)(2)(i).

in a number of statutory exemptions from the prohibited transaction provisions of the Act. In determining whether a statutory exemption applies to a particular transaction, the burden of proof is upon the party seeking to make use of the statutory exemption to show that all the requirements of the provision are met. *Donovan v. Cunningham, supra*, 716 F.2d at 1467 n.27. In the Department's view, written documentation relating to the valuation is necessary for a determination of how, and on what basis, an asset was valued, and therefore whether that valuation reflected an asset's fair market value. In addition, the Department believes that it would be contrary to prudent business practices for a fiduciary to act in the absence of such written documentation of fair market value.

3. Good Faith

The second part of the Department's proposed two-part test under section 3(18)(B) and section 8477(a)(2)(B) requires that an assessment of adequate consideration be the product of a determination made in good faith by the plan trustee or named fiduciary (or under FERSA, a fiduciary). Proposed § 2510.3-18(b)(3)(i) states that as a general matter this good faith requirement establishes an objective standard of conduct, rather than mandating an inquiry into the intent or state of mind of the plan trustee or named fiduciary. In this regard, the proposal is consistent with the opinion in *Donovan v. Cunningham, supra*, where the court stated that the good faith requirement in section 3(18)(B):

> is not a search for subjective good faith * * * The statutory reference to good faith in Section 3(18) must be read in light of the overriding duties of Section 404.

716 F.2d at 1467. The inquiry into good faith under the proposal therefore focuses on the fiduciary's conduct in determining fair market value. An examination of all relevant facts and circumstances is necessary for a determination of whether a fiduciary has met this objective good faith standard.

Proposed § 2510.3-18(b)(3)(ii) focuses on two factors which must be present in order for the Department to be satisfied that the fiduciary has acted in good faith. First, this section would require a fiduciary to apply sound business principles of evaluation and to conduct a prudent investigation of the circumstances prevailing at the time of the valuation. This requirement reflects the *Cunningham* court's emphasis on the use of prudent business practices in valuing plan assets.

Second, this section states that either the fiduciary making the valuation must itself be independent of all the parties to the transaction (other than the plan), or the fiduciary must rely on the report of an appraiser who is independent of all the parties to the transaction (other than the plan). (The criteria for determining independence are discussed below.) As noted above, under ERISA, the determination of adequate consideration is a central safeguard in many statutory exemptions applicable to plan transactions with the plan sponsor. The close relationship between the plan and the plan sponsor in such situations raises a significant potential for conflicts of interest as the fiduciary values assets which are the subject of transactions between the plan and the plan sponsor. In light of this possibility, the Department believes that good faith may only be demonstrated when the valuation is made by persons independent of the parties to the transaction (other than the plan), *i.e.*, a valuation made by an independent fiduciary or by a fiduciary acting pursuant to the report of an independent appraiser.

The Department emphasizes that the two requirements of proposed § 2510.3-18(b)(3)(ii) are designed to work in concert. For example, a plan fiduciary charged with valuation may be independent of all the parties to a transaction and may, in light of the requirement of proposed § 2510.3-18(b)(3)(ii)(B), decide to undertake the valuation process itself. However, if the independent fiduciary has neither the experience, facilities nor expertise to make the type of valuation under consideration, the decision by that fiduciary to make the valuation would fail to meet the prudent investigation and sound business principles requirement of proposed § 2510.3-18(b)(3)(ii)(A).

Proposed § 2510.3-18(b)(3)(iii) defines the circumstances under which a fiduciary or an appraiser will be deemed to be independent for the purposes of subparagraph (3)(ii)(B), above. The proposal notes that the fiduciary or the appraiser must in fact be independent of all parties participating in the transaction other than the plan. The proposal also notes that a determination of independence must be made in light of all relevant facts and circumstances, and then delineates certain circumstances under which this independence will be lacking. These circumstances reflect the definitions of the terms "affiliate" and "control" in Departmental regulation 29 CFR 2510.3-21(e) (defining the circumstances under which an investment adviser is a fiduciary). It should be noted that, under these proposed provisions, an appraiser will be considered independent of all parties to a transaction (other than the plan) only if a plan fiduciary has chosen the appraiser and has the right to terminate that appointment, and the plan is thereby established as the appraiser's client.[3] Absent

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[3] The independence of an appraiser will not be affected solely because the plan sponsor pays the appraiser's fee.

such circumstances, the appraiser may be unable to be completely neutral in the exercise of his function.[4]

4. Valuation Content — General

Proposed § 2510.3-18(b)(4)(i) sets the content requirements for the written documentation of valuation required for a determination of fair market value under proposed § 2510.3-18(b)(2)(iii). The proposal follows to a large extent the requirements of Rev. Proc. 66-49, 1966-2 C.B. 1257, which sets forth the format required by the IRS for the valuation of donated property. The Department believes that this format is a familiar one, and will therefore facilitate compliance. Several additions to the IRS requirements merit brief explanation.

First, proposed paragraph (b)(4)(i)(E) requires a statement of the purpose for which the valuation was made. A valuation undertaken, for example, for a yearly financial report may prove an inadequate basis for any sale of the asset in question. This requirement is intended to facilitate review of the valuation in the correct context.

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[4] With regard to this independence requirement the Department notes that new section 401(a)(28) of the Code (added by section 1175(a) of the Tax Reform Act of 1986) requires that, in the case of an employee stock ownership plan, employer securities which are not readily tradable on established securities markets must be valued by an independent appraiser. New section 401(a)(28)(C) states that the term "independent appraiser" means an appraiser meeting requirements similar to the requirements of regulations under section 170(a)(1) of the Code (relating to IRS verification of the value assigned for deduction purposes to assets donated to charitable organizations). The Department notes that the requirements of proposed regulation § 2510.3-18(b)(3)(iii) are not the same as the requirements of the regulations issued by the IRS under section 170(a)(1) of the Code. The IRS has not yet promulgated rules under Code section 401(a)(28).

Second, proposed paragraph (b)(4)(i)(F) requires a statement as to the relative weight accorded to relevant valuation methodologies. The Department's experience in this area indicates that there are a number of different methodologies used within the appraisal industry. By varying the treatment given and emphasis accorded relevant information, these methodologies directly affect the result of the appraiser's analysis. It is the Department's understanding that appraisers will often use different methodologies to cross-check their results. A statement of the method or methods used would allow for a more accurate assessment of the validity of the valuation.

Finally, proposed subparagraph (b)(4)(i)(G) requires a statement of the valuation's effective date. This reflects the requirement in proposed § 2510.3-18(b)(ii) that fair market value must be determined as of the date of the transaction in question.

5. Valuation Content — Special Rule

Proposed § 2510.3-18(b)(4)(ii) establishes additional content requirements for written documentation of valuation when the asset being appraised is a security other than a security for which there is a generally recognized market. In other words, the requirements of the proposed special rule supplement, rather than supplant, the requirements of paragraph (b)(4)(i). The proposed special rule establishes a nonexclusive list of factors to be considered when the asset being valued is a security not covered by section 3(18)(A) of the Act or section 8477(a)(2)(A) of FERSA. Such securities pose special valuation problems because they are not traded or are so thinly traded that it is difficult to assess the effect on such securities of the market forces usually considered in determining fair market value. The

Internal Revenue Service has had occasion to address the valuation problems posed by one type of such securities — securities issued by closely held corporations. Rev. Rul. 59-60, 1959-1 Cum. Bull. 237, lists a variety of factors to be considered when valuing securities of closely held corporations for tax purposes.[5] The Department's experience indicates that Rev. Rul. 59-60 is familiar to plan fiduciaries, plan sponsors and the corporate community in general. The Department has, therefore, modeled this proposed special rule after Rev. Rul. 59-60 with certain additions and changes discussed below. It should be emphasized, however, that this is a non-exclusive list of factors to be considered. Certain of the factors listed may not be relevant to every valuation inquiry, although the fiduciary will bear the burden of demonstrating such irrelevance. Similarly, reliance on this list will not relieve fiduciaries from the duty to consider all relevant facts and circumstances when valuing such securities. The purpose of the proposed list is to guide fiduciaries in the course of their inquiry.

Several of the factors listed in proposed § 2510.3-18 (b)(4)(ii) merit special comment and explanation. Proposed subparagraph (G) states that the fair market value of securities other than those for which there is a generally recognized market may be established by reference to the market price of similar securities of corporations engaged in the same or a similar line of business whose securities are actively traded in a free

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5 Rev. Rul. 59-60 was modified by Rev. Rul 65-193 (1965-2 C.B. 370) regarding the valuation of tangible and intangible corporate assets. The provisions of Rev. Rul. 59-60, as modified, were extended to the valuation of corporate securities for income and other tax purposes by Rev. Rul. 68-609 (1968-2 C.B. 327). In addition, Rev. Rul. 77-287 (1977-2 C.B. 319). amplified Rev. Rul. 59-60 by indicating the ways in which the factors listed in Rev. Rul. 59-60 should be applied when valuing restricted securities.

and open market, either on an exchange or over the counter. The Department intends that the degree of comparability must be assessed in order to approximate as closely as possible the market forces at work with regard to the corporation issuing the securities in question.

Proposed subparagraph (H) requires an assessment of the effect of the securities' marketability or lack thereof. Rev. Rul. 59-60 does not explicitly require such an assessment, but the Department believes that the marketability of these types of securities will directly affect their price. In this regard, the Department is aware that, especially in situations involving employee stock ownership plans (ESOPs),[6] the employer securities held by the ESOP will provide a "put" option whereby individual participants may upon retirement sell their shares back to the employer.[7] It has been argued that some kinds of "put" options may diminish the need to discount the value of the securities due to lack of marketability. The Department believes that the existence of the "put" option should be considered for valuation purposes only to the extent it is enforceable and the employer has and may reasonably be expected to continue to have, adequate resources to meet its obligations. Thus, the Department proposes to require that the plan fiduciary assess whether these "put" rights are

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6 The definition of the term "adequate consideration" under ERISA is of particular importance to the establishment and maintenance of ESOPs because, pursuant to section 408(e) of the Act, an ESOP may acquire employer securities from a party in interest only under certain conditions, including that the plan pay no more than adequate consideration for the securities.

7 Regulation 29 CFR 2550.408b-(j) requires such a put option in order for a loan from a party in interest to the ESOP to qualify for the statutory exemption in section 408(b)(3) of ERISA from the prohibited transactions provisions of ERISA.

actually enforceable, and whether the employer will be able to pay for the securities when and if the "put" is exercised.

Finally, proposed subparagraph (I) deals with the role of control premiums in valuing securities other than those for which there is a generally recognized market. The Department proposes that a plan purchasing control may pay a control premium, and a plan selling control should receive a control premium. Specifically, the Department proposes that a plan may pay such a premium only to the extent a third party would pay a control premium. In this regard, the Department's position is that the payment of a control premium is unwarranted unless the plan obtains both voting control and control in fact. The Department will therefore carefully scrutinize situations to ascertain whether the transaction involving payment of such a premium actually results in the passing of control to the plan. For example, it may be difficult to determine that a plan paying a control premium has received control in fact where it is reasonable to assume at the time of acquisition that distribution of shares to plan participants will cause the plan's control of the company to be dissipated within a short period of time subsequent to acquisition.[8] In the Department's view, however, a plan would not fail to receive control merely because individuals who were previously officers, directors or shareholders of the corporation continue as plan fiduciaries or corporate officials after the plan has acquired the securities. Nonetheless, the

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[8] However, the Department notes that the mere pass-through of voting rights to participants would not in itself affect a determination that a plan has received control in fact, notwithstanding the existence of participant voting rights, if the plan fiduciaries having control over plan assets ordinarily may resell the shares to a third party and command a control premium, without the need to secure the approval of the plan participants.

retention of management and the utilization of corporate officials as plan fiduciaries, when viewed in conjunction with other facts, may indicate that actual control has not passed to the plan within the meaning of paragraph (b)(4)(ii)(I) of the proposed regulation. Similarly, if the plan purchases employer securities in small increments pursuant to an understanding with the employer that the employer will eventually sell a controlling portion of shares to the plan, a control premium would be warranted only to the extent that the understanding with the employer was actually a binding agreement obligating the employer to pass control within a reasonable time. *See Donovan v. Cunningham, supra*, 716 F.2d at 1472-74 (mere intention to transfer control not sufficient).

6. Service Arrangements Subject to FERSA

Section 8477(c)(1)(C) of FERSA permits the exchange of services between the Thrift Savings Fund and a party in interest only in exchange for adequate consideration. In this context, the proposal defines the term "adequate consideration" as "reasonable compensation," as that term is described in sections 408(b)(2) and 408(c)(2) of ERISA and the regulations promulgated thereunder. By so doing, the proposal would establish a consistent standard of exemptive relief for both ERISA and FERSA with regard to what otherwise would be prohibited service arrangements.

Regulatory Flexibility Act

The Department has determined that this regulation would not have a significant economic effect on small plans. In conducting the analysis required under the Regulatory Flexibility Act, it was estimated that

approximately 6,250 small plans may be affected by the regulation. The total additional cost to these plans, over and above the costs already being incurred under established valuation practices, are estimated not to exceed $875,000 per year, or $140 per plan for small plans choosing to engage in otherwise prohibited transactions that are exempted under the statute conditioned on a finding of adequate consideration.

Executive Order 12291

The Department has determined that the proposed regulatory action would not constitute a "major rule" as that term is used in Executive Order 12291 because the action would not result in: an annual effect on the economy of $100 million; a major increase in costs of prices for consumers, individual industries, government agencies, or geographical regions; or significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States based enterprises to compete with foreign based enterprises in domestic or export markets.

Paperwork Reduction Act

This proposed regulation contains several paperwork requirements. The regulation has been forwarded for approval to the Office of Management and Budget under the provisions of the Paperwork Reduction Act of 1980 (Pub. L. 96-511). A control number has not yet been assigned.

Statutory Authority

This regulation is proposed under section 3(18) and 505 of the Act (29 U.S.C. 1003(18) and 1135); Secretary

of Labor's Order No. 1-87; and sections 8477(a)(2)(B) and 8477(f) of FERSA.

List of Subjects in 29 CRF Part 2510

Employee benefit plans, Employee Retirement Income Security Act, Pensions, Pension and Welfare Benefit Administration.

Proposed Regulation

For the reasons set out in the preamble, the Department proposes to amend Part 2510 of Chapter XXV of Title 29 of the Code of Federal Regulations as follows:

PART 2510 — [AMENDED]

1. The authority for Part 2510 is revised to read as follows:

Authority: Sec. 3(2), 111(c), 505, Pub. L. 93-406, 88 Stat. 852, 894, (29 U.S.C. 1002(2), 1031, 1135); Secretary of Labor's Order No 27-74, 1-86, 1-87, and Labor Management Services Administration Order No. 2-6.

Section 2510.3-18 is also issued under sec. 3(18) of the Act (29 U.S.C. 1003(18)) and secs. 8477(a)(2)(B) and (f) of FERSA (5 U.S.C. 8477)

Section 2510.3-101 is also issued under sec. 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), effective December 31, 1978 (44 FR 1065, January 3, 1978); 3 CFR 1978 Comp. 332, and sec. 11018(d) of Pub. L. 99-272, 100 Stat. 82.

Section 2510.3-102 is also issued under sec. 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713,

October 17, 1978), effective December 31, 1978 (44 FR 1065, January 3, 1978), and 3 CFR 1978 Comp. 332.

2. Section 2510.3-18 is added to read as follows:

§2510.3-18 Adequate Consideration

(a) [Reserved]

(b)(1)(i) *General.* (A) Section 3(18)(B) of the Employee Retirement Income Security Act of 1974 (the Act) provides that, in the case of a plan asset other than a security for which there is a generally recognized market, the term "adequate consideration" when used in Part 4 of Subtitle B of Title I of the Act means the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary of Labor.

(B) Section 8477(a)(2)(B) of the Federal Employees' Retirement System Act of 1986 (FERSA) provides that, in the case of an asset other than a security for which there is a generally recognized market, the term "adequate consideration" means the fair market value of the asset as determined in good faith by a fiduciary or fiduciaries in accordance with regulations prescribed by the Secretary of Labor.

(ii) *Scope.* The requirements of section 3(18)(B) of the Act and section 8477(a)(2)(B) of FERSA will not be met unless the value assigned to a plan asset both reflects the asset's fair market value as defined in paragraph (b)(2) of this section and results from a determination made by the plan trustee or named fiduciary (or, in the case of FERSA, a fiduciary) in good faith as described in paragraph (b)(3) of this section. Paragraph (b)(5) of this section contains a special rule for service contracts subject to FERSA.

(2) *Fair Market Value.* (i) Except as otherwise specified in this section, the term "fair market value" as used in section 3(18)(B) of the Act and section 8477(a)(2)(B) of FERSA means the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell and both parties are able, as well as willing, to trade and are well informed about the asset and the market for such asset.

(ii) The fair market value of an asset for the purposes of section 3(18)(B) of the Act and section 8477(a)(2)(B) of FERSA must be determined as of the date of the transaction involving that asset.

(iii) The fair market value of an asset for the purposes of section 3(18)(B) of the Act and section 8477(a)(2)(B) of FERSA must be reflected in written documentation of valuation meeting the requirements set forth in paragraph (b)(4), of this section.

(3) *Good Faith* — (i) *General Rule.* The requirement in section 3(18)(B) of the Act and section 8477(a)(2)(B) of FERSA that the fiduciary must determine fair market value in good faith establishes an objective, rather than a subjective, standard of conduct. Subject to the conditions in paragraphs (b)(3)(ii) and (iii) of this section, an assessment of whether the fiduciary has acted in good faith will be made in light of all relevant facts and circumstances.

(ii) In considering all relevant facts and circumstances, the Department will not view a fiduciary as having acted in good faith unless

(A) The fiduciary has arrived at a determination of fair market value by way of a prudent investigation of circumstances prevailing at the time of the valuation,

and the application of sound business principles of evaluation; and

(B) The fiduciary making the valuation either,

(1) Is independent of all parties to the transaction (other than the plan), or

(2) Relies on the report of an appraiser who is independent of all parties to the transaction (other than the plan).

(iii) In order to satisfy the independence requirement of paragraph (b)(3)(ii)(B), of this section, a person must in fact be independent of all parties (other than the plan) participating in the transaction. For the purposes of this section, an assessment of independence will be made in light of all relevant facts and circumstances. However, a person will not be considered to be independent of all parties to the transaction if that person —

(1) Is directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with any of the parties to the transaction (other than the plan);

(2) Is an officer, director, partner, employee, employer or relative (as defined in section 3(15) of the Act, and including siblings) of any such parties (other than the plan);

(3) Is a corporation or partnership of which any such party (other than the plan) is an officer, director or partner.

For the purposes of this subparagraph, the term "control," in connection with a person other than an individual, means the power to exercise a controlling influence over the management or policies of that person.

(4) *Valuation Content.* (i) In order to comply with the requirement in paragraph (b)(2)(iii), of this section,

that the determination of fair market value be reflected in written documentation of valuation, such written documentation must contain, at a minimum, the following information:

(A) A summary of the qualifications to evaluate assets of the type being valued of the person or persons making the valuation;

(B) A statement of the asset's value, a statement of the methods used in determining that value, and the reasons for the valuation in light of those methods;

(C) A full description of the asset being valued;

(D) The factors taken into account in making the valuation, including any restrictions, understandings, agreements or obligations limiting the use or disposition of the property;

(E) The purpose for which the valuation was made;

(F) The relevance or significance accorded to the valuation methodologies taken into account;

(G) The effective date of the valuation; and

(H) In cases where a valuation report has been prepared, the signature of the person making the valuation and the date the report was signed.

(ii) *Special Rule*. When the asset being valued is a security other than a security covered by section 3(18)(A) of the Act or section 8477(a)(2)(A) of FERSA, the written valuation required by paragraph (b)(2)(iii) of this section, must contain the information required in paragraph (b)(4)(i) of this section, and must include, in addition to an assessment of all other relevant factors, an assessment of the factors listed below:

(A) The nature of the business and the history of the enterprise from its inception;

(B) The economic outlook in general, and the condition and outlook of the specific industry in particular;

(C) The book value of the securities and the financial condition of the business;

(D) The earning capacity of the company;

(E) The dividend-paying capacity of the company;

(F) Whether or not the enterprise has goodwill or other intangible value;

(G) The market price of securities of corporations engaged in the same or a similar line of business, which are actively traded in a free and open market, either on an exchange or over-the-counter;

(H) The marketability, or lack thereof, of the securities. Where the plan is the purchaser of securities that are subject to "put" rights and such rights are taken into account in reducing the discount for lack of marketability, such assessment shall include consideration of the extent to which such rights are enforceable, as well as the company's ability to meet its obligations with respect to the "put" rights (taking into account the company's financial strength and liquidity);

(I) Whether or not the seller would be able to obtain a control premium from an unrelated third party with regard to the block of securities being valued, provided that in cases where a control premium is taken into account:

(*1*) Actual control (both in form and in substance) is passed to the purchaser with the sale, or will be passed to the purchaser within a reasonable time pursuant to a binding agreement in effect at the time of the sale, and

(2) It is reasonable to assume that the purchaser's control will not be dissipated within a short period of time subsequent to acquisition.

(5) *Service Arrangements Subject to FERSA.* For purposes of determinations pursuant to section 8477(c)(1)(C) of FERSA (relating to the provision of services)

the term "adequate consideration" under section 8477(a)(2)(B) of FERSA means "reasonable compensation" as defined in sections 408(b)(2) and 408(c)(2) of the Act and §§ 2550.408b-2(d) and 2550.408c-2 of this chapter.

(6) *Effective Date.* This section will be effective for transactions taking place after the date 30 days following publication of the final regulation in the **Federal Register**.

Signed in Washington, DC, this 11th day of May 1988.

David M. Walker,

Assistant Secretary, Pension and Welfare Benefits Administration, U.S. Department of Labor.

[FR Doc. 88-10934 Filed 5-16-88; 8:45 am]

APPENDIX J

LABOR CODE

29 U.S.C. § 1002. Definitions

* * *

(18) The term "adequate consideration" when used in part 4 of subtitle B of this subchapter means (A) in the case of a security for which there is a generally recognized market, either (i) the price of the security prevailing on a national securities exchange which is registered under section 78f of Title 15, or (ii) if the security is not traded on such a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of any party in interest; and (B) in the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary.

29 U.S.C. §1104. Fiduciary duties

(a) Prudent man standard of care

(1) Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and —

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar

with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter or subchapter III of this chapter.

29 U.S.C. § 1106. Prohibited transactions

(a) Transactions between plan and party in interest

Except as provided in section 1108 of this title:

(1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect —

(A) sale or exchange, or leasing, of any property between the plan and a party in interest;

(B) lending of money or other extension of credit between the plan and a party in interest;

(C) furnishing of goods, services, or facilities between the plan and a party in interest;

(D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or

(E) acquisition on behalf of the plan, of any employer security or employer real property in volation of section 1107(a) of this title.

(2) No fiduciary who has authority or discretion to control or manage the assets of a plan shall permit the plan to hold any employer security or employer real property if he knows or should know that holding such security or real property violates section 1107(a) of this title.

(b) Transactions between plan and fiduciary

A fiduciary with respect to a plan shall not —

(1) deal with the assets of the plan in his own interest or for his own account,

(2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or

(3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

(c) Transfer of real or personal property to plan by party in interest

A transfer of real or personal property by a party in interest to a plan shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the plan assumes or if it is subject to a mortgage or similar lien which a party-in-interest placed on the property within the 10-year period ending on the date of the transfer.
(Pub.L. 93-406, Title I, § 406, Sept. 2, 1974, 88 Stat. 879.)

29 U.S.C. § 1108. Exemptions from prohibited transactions

(a) Grant of exemptions

The Secretary shall establish an exemption procedure for purposes of this subsection. Pursuant to such procedure, he may grant a conditional or unconditional exemption of any fiduciary or transaction, or class of fiduciaries or transactions, from all or part of the restrictions imposed by sections 1106 and 1107(a) of this title. Action under this subsection may be taken only after consultation and coordination with the Secretary of the Treasury. An exemption granted under this section shall not relieve a fiduciary from any other applicable provision of this chapter. The Secretary may not grant an exemption under this subsection unless he finds that such exemption is —

(1) administratively feasible,

(2) in the interests of the plan and of its participants and beneficiaries, and

(3) protective of the rights of participants and beneficiaries of such plan.

Before granting an exemption under this subsection from section 1106(a) or 1107(a) of this title, the Secretary shall publish notice in the Federal Register of the pendency of the exemption, shall require that adequate notice be given to interested persons, and shall afford interested persons opportunity to present views. The Secretary may not grant an exemption under this subsection from section 1106(b) of this title unless he affords an opportunity for a hearing and makes a determination on the record with respect to the findings required by paragraphs (1), (2), and (3) of this subsection.

* * *

(e) Acquisition or sale by plan of qualifying employer securities; acquisition, sale, or lease by plan of qualifying employer real property

Sections 1106 and 1107 of this title shall not apply to the acquisition or sale by a plan of qualifying employer securities (as defined in section 1107(d)(5) of this title) or acquisition, sale or lease by a plan of qualifying employer real property (as defined in section 1107(d)(4) of this title) —

(1) if such acquisition, sale, or lease is for adequate consideration (or in the case of a marketable obligation, at a price not less favorable to the plan than the price determined under section 1107(e)(1) of this title),

(2) if no commission is charged with respect thereto, and

(3) if —

(A) the plan is an eligible individual account plan (a defined in section 1107(d)(3) of this title), or

(B) in the case of an acquisition or lease of qualifying employer real property by a plan which is not an eligible individual account plan, or of an acquisition of qualifying employer securities by such a plan, the lease or acquisition is not prohibited by section 1107(a) of this title.

29 U.S.C. § 1144. Other laws

(a) Supersedure; effective date

Except as provided in subsection (b) of this section, the provisions of this subchapter and subchapter III of this chapter shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan described in section 1003(a) of this title and not exempt under section 1003(b) of this title.

INTERNAL REVENUE CODE

26 U.S.C § 4975. Tax on prohibited transactions

(a) Initial taxes on disqualified person. — There is hereby imposed a tax on each prohibited transaction. The rate of tax shall be equal to 5 percent of the amount involved with respect to the prohibited transaction for each year (or part thereof) in the taxable period. The tax imposed by this subsection shall be paid by any disqualified person who participates in the prohibited transaction (other than a fiduciary acting only as such).

(b) Additional taxes on disqualified person. — In any case in which an initial tax is imposed by subsection (a) on a prohibited transaction and the transaction is not corrected within the taxable period, there is hereby imposed a tax equal to 100 percent of the amount involved. The tax imposed by this subsection shall be paid by any disqualified person who participated in the prohibited transaction (other than a fiduciary acting only as such).

(c) Prohibited transaction. —

(1) General rule. — For purposes of this section, the term "prohibited transaction" means any direct or indirect —

(A) sale or exchange, or leasing, of any property between a plan and a disqualified person;

(B) lending of money or other extension of credit between a plan and a disqualified person;

(C) furnishing of goods, services, or facilities between a plan and a disqualified person;

(D) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;

(E) act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interest or for his own account; or

(F) receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

* * *

(d) **Exemptions.** — The prohibitions provided in subsection (c) shall not apply to —

* * *

(13) any transaction which is exempt from section 406 of such Act by reason of section 408(e) of such Act (or which would be so exempt if such section 406 applied to such transaction) or which is exempt from section 406 of such Act by reason of section 408(b) of such Act;

CALIFORNIA CORPORATION CODE

Chapter 18
INVOLUNTARY DISSOLUTION

§ 1800. Verified complaint; plaintiffs; grounds; intervention by shareholder or creditor; exempt corporations

(a) A verified complaint for involuntary dissolution of a corporation on any one or more of the grounds specified in subdivision (b) may be filed in the superior court of the proper county by any of the following persons:

. . . .

(2) A shareholder or shareholders who hold shares representing not less than 33-1/3 percent of (i) the total number of outstanding shares (assuming conversion of any preferred shares convertible into common shares) or (ii) the outstanding common shares or (iii) the equity of the corporation, exclusive in each case of shares owned by persons who have personally participated in any of the transactions enumerated in paragraph (4) of subdivision (b), or any shareholder or shareholders of a close corporation.

. . . .

(b) The grounds for involuntary dissolution are that:

(1) The corporation has abandoned its business for more than one year.

(2) The corporation has an even number of directors who are equally divided and cannot agree as to the management of its affairs, so that its business can no longer be conducted to advantage or so that there is danger that its property and business will be impaired or lost, and the holders of the voting shares of the corpora-

tion are so divided into factions that they cannot elect a board consisting of an uneven number.

(3) There is internal dissension and two or more factions of shareholders in the corporation are so deadlocked that its business can no longer be conducted with advantage to its shareholders or the shareholders have failed at two consecutive annual meetings at which all voting power was exercised, to elect successors to directors whose terms have expired or would have expired upon election of their successors.

(4) Those in control of the corporation have been guilty of or have knowingly countenanced persistent and pervasive fraud, mismanagement or abuse of authority or persistent unfairness toward any shareholders or its property is being misapplied or wasted by its directors or officers.

(5) In the case of any corporation with 35 or fewer shareholders (determined as provided in Section 605), liquidation is reasonably necessary for the protection of the rights or interests of the complaining shareholder or shareholders.

(6) The period for which the corporation was formed has terminated without extension of such period.

§ 1804. Decree for winding up and dissolution; other judicial relief

After hearing the court may decree a winding up and dissolution of the corporation if cause therefor is shown or, with or without winding up and dissolution, may make such orders and decrees and issue such injunctions in the case as justice and equity require.

No. 96-1580

Supreme Court, U.S.
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IN THE
Supreme Court of the United States
OCTOBER TERM, 1996

EDWARD A. SHAY, MARTIN L. LEHRER, RICHARD L. SMITH, ALLEN E. SHAY, and PACIFIC ARCHITECTS AND ENGINEERS, INCORPORATED,
Petitioners,

vs.

NEWMAN HOWARD, GILBERT LEON ALLEN, JOAN HOWARD and THEODORE H. POPE as representatives of plan participants similarly situated on behalf of THE EMPLOYEE STOCK OWNERSHIP PLAN OF PACIFIC ARCHITECTS AND ENGINEERS INCORPORATED,
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BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

RAYMOND G. KOLTS
Counsel of Record

GARY C. NAWA
KATHLENE LANDGRAF KOLTS

KOLTS AND NAWA

215 North Marengo Avenue, Suite 195
Pasadena, California 91101-1505
(818) 584-6968

Attorneys for Respondents

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KOLTS AND NAWA

215 North Marengo Avenue, Suite 195
Pasadena, California 91101-1505
(818) 584-6968

Attorneys for Respondents

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REVIEW BY THE UNITED STATES SUPREME COURT IS NOT WARRANTED

United States Supreme Court Rule 10 admonishes potential petitioners that a Writ of Certiorari will be granted only for *compelling* reasons. No compelling reasons exist in the instant case. There are no constitutional issues presented, no conflicts with the decisions of a state court of last resort, the circuits, or this court.

The Ninth Circuit Court of Appeal applied hundreds of years of trust law, the mandates of ERISA, and its decision is in conformance with all circuits that have analyzed issues of fiduciary duty with respect to Employee Stock Ownership Plans ("ESOPs"). While deciding an issue of major import to the litigants, the Ninth Circuit has not decided a federal question in a way that either conflicts with relevant decisions of this court, or is unique. There is no departure from accepted and usual judicial proceedings whatsoever.

The "Questions Presented" by the petitioners have been answered uniformly amongst the circuits, and the Ninth Circuit Court of Appeal in reversing the United States District Court's decision. Pursuant to Rule 15.2, respondents object to petitioners' brief to the extent that it challenges or seeks to correct *valuation* issues, which are not ripe for decision, and have not yet been decided on remand by the district court.

With respect to California Corporations Code § 1800, the application of state corporate securities law is specifically sanctioned by ERISA, the Internal Revenue, and the Department of Labor, and is consistent with all circuit courts that have analyzed this valuation process, and valuation issues in stock transfers generally.

The petitioners assert that a conflicted fiduciary can blindly rely on a retained valuation expert without questioning or investigating the assumptions or the conclusion. Such conduct is not authorized by ERISA, not supported in case law interpreting fiduciary duties, and certainly not raised to the status of a conflict. The circuit courts are in accord that a fiduciary must conduct an independent investigation of the transaction. Further, ERISA contemplates fiduciaries not predetermining the results. Conduct such as displayed by the fiduciaries in the instant case would not be condoned under any circuit court rationale.

There are no special or important reasons for the United States Supreme Court to review the conduct of conflicted corporate officers/ERISA fiduciaries who decided *in advance* to accept a predetermined appraisal, concocted and molded to fit the desires of a controlling shareholder and fellow fiduciary, who also happened to be the President of the Company, and indirect purchaser of the stock. This is certainly true in light of the uncontroverted fact that the controlling shareholder (Edward A. Shay) was seeking at the outset of the ESOP termination to "pay as little as he could get away with", and to regain 100% control of his company as an estate planning device, for the benefit of his heirs, including his son, Allen Shay, now president of Pacific Architects & Engineers. (RT: XII:64:12-19)

The standard of review was correct. The Ninth Circuit Court of Appeals' decision was correct. There is no issue to be decided by the United States Supreme Court.

STATEMENT OF THE CASE

Petitioner, Pacific Architects and Engineers, Incorporated ("PAE") is a California corporation that is

primarily a real estate holding company, owning domestic and foreign property, as well as being engaged in engineering and architectural operations worldwide (A 3). In 1974, the 100% shareholder, Edward A. Shay ("Shay") authorized the creation of an ESOP, and sold 40% of PAE stock to the ESOP at $10.67 a share (based on PAE's appraised value of $10,670,000. (A 3). In 1988, Shay instructed that the ESOP be terminated, and that family trusts controlled by him purchase the employee's 40% block of stock "for as little as he could get away with". The district court record reveals that the purpose of the termination of the ESOP was part of Shay's estate planning for his son, co-defendant, Allen Shay (Ex. 31; 47, 50; RT: IV:58:8-59:17).

At all times during the pendency of the ESOP, defendants/respondents Shay, Lehrer and Smith were senior executives of PAE and the entirety of the Board of Directors. They were the three fiduciaries of the ESOP at the time of termination in 1988. (A 3). Both Lehrer and Smith had worked directly for Shay for many years, and admitted repeatedly that Shay had absolute control over PAE, and all of the employees of this privately held corporation. (RT I:141:23-142:1, RT: IV:83:13)

In 1988, after shopping around unsuccessfully for other appraisers, Smith hired Arthur Young ("AY") to value the stock on the conditions that the valuator would agree in advance to limit its investigation, accept the characterization of the corporation as given by the conflicted fiduciaries, and not contact the joint venturer of PAE, Jardine Mathison (which owned 50% of K.K. Halifax, the largest asset of PAE) (A 4). In July 1988, months before the final evaluation was printed, PAE informed AY that Shay would be purchasing the ESOP's stock (A 4).

Prior to the valuation or appraisal by AY, the fiduciaries agreed in advance, without even seeing the appraisal, to accept AY's valuation as the sale price of the stock to Shay or his nominee (A 4). The fiduciaries did not review, discuss or question the valuation (A 11), and voted to sell the stock to the nominee of Shay (his heirs) for $14.40 a share, a mere 17¢ on the appraised dollar value of $83.42 per share (A 6). The nominee was a trust concurrently created for the benefit of Allen Shay, to allow the aging and infirm Shay to reacquire 100% of the company that he controlled and had founded. (Shay died in 1995.) The vote agreeing to $14.40 a share represented a compound growth rate of the stock of 2.2% from 1974 through 1988 (A 3). This rate was deemed appropriate by the conflicted fiduciaries even with full knowledge that the real estate holding assets of PAE included properties in Tokyo and Los Angeles which had been appraised for over $78 million dollars, an eight fold increase during the life of the ESOP. (Ex. 17: 17174-79)

PAE supplied information to AY, which relied completely on the information, without investigation. AY's qualifications to its evaluations stated clearly that:

> We have relied upon the assertion of management and other third parties that the financial data and real estate appraisal reports described in this report provide a reasonable representation of fair market value and historical operation of the company and the condition of [PAE's] real estate investments. (A 4-A 5).

AY further relied on PAE's attorney (the same law firm representing PAE in the instant litigation) that California Corporations Code § 1800 did not give the ESOP any rights to trigger an involuntary dissolution. The district court

record reveals that PAE's attorney denied giving any legal opinions as to the impact of § 1800, but rather referred to her conclusions as an "explication". The record is devoid of any case law, legal reasoning or legislative history that supported the "explications" of PAE's corporate attorney in interpreting § 1800.

Fiduciary Smith signed an Officer's Certificate stating the ESOP had no remedies under § 1800 (Ex. 17:17239) but admitted total ignorance as to the basis or accuracy of his conclusion. The regular counsel to the ESOP was never even consulted on this issue. (RT: II:128:19-129:22; V:57:4-8).

The Ninth Circuit offered a different perspective on § 1800, one that most assuredly should have occurred to the conflicted fiduciaries:

> We agree with plaintiffs that the *district court erred in finding that ERISA preempts Cal. Corp. Code § 1800.* 29 U.S.C. § 1144; *see Aloha Airlines, Inc. v. Ahue*, 12 F.3d 1498, 1504 (9th Cir. 1993). It seems, however, that *even if ERISA did preempt Cal. Corp. Code § 1800, the statute would nevertheless deflate Pacific's minority interest discount, since a third-party buyer would be entitled to its possible benefit.* (Emphasis added.) (A 10)

Based on the representations of the conflicted fiduciaries, AY valued PAE at $83.42 per share. It then applied various discounts and arrived at the purported fair market value of the stock to be sold by the ESOP to Shay of $14.40 a share. The district court and the Ninth Circuit both found that the fiduciaries had a conflict of interest and thus had the burden of establishing that the sale price was for "adequate consideration" and fair market value (A 8,

E 5). The district court erroneously applied the "business judgment rule," a creation of corporate law, having nothing whatsoever to do with fiduciary duties or ERISA. By applying a completely incorrect legal standard, the district court found no breach of duty (D 9, No. 8).

On appeal, the United States Department of Labor filed an amicus curiae brief in support of the position of respondents as did the American Association of Retired Persons (AARP) (separately and concurrently lodged with respondent's opposition). The Ninth Circuit was not only in possession of the entire record of the district court, but the opinions of the Department of Labor, and a group of affected and interested persons represented by the AARP. Both briefs asserted that the transaction was tainted, not for adequate consideration, and that the "business judgment rule" would not only be erroneous, but have tragic and improper consequences for millions of workers whose pension plans could be undermined by business vagaries as opposed to protected by trust principles. The AARP observed that the district court opinion threatened the retirement security of 11.3 million employees. (Citing M. A. Conte & H. H. Lawrence, "Trends in ESOPs", in *Trends in Pensions 1992*, U.S. Department of Labor, Pension & Welfare Benefits Administration.)

On November 22, 1996, the Ninth Circuit Court of Appeal reversed the district court's decision of October 1, 1993. A Petition for Rehearing En Banc was filed by the Shay defendants, but no Ninth Circuit judge voted to hear the matter en banc (C 2). The Ninth Circuit decided *only* the question of fiduciary duty. No opinion was rendered as to the true and proper fair market value of the ESOP block of stock. This matter was properly remanded to the district court, which action has now been stayed pending this Petition for Writ of Certiorari.

With respect to the outcome presently before this court, the Ninth Circuit found:

> . . . that even if the district court applied the prudent man standard, it did not apply it correctly. The fiduciaries failed to carry their burden of proving that they fulfilled their duties of care and loyalty and that the ESOP received adequate consideration. (A 9).
>
> . . . Even a cursory review of the Arthur Young valuation and fairness opinion reveals the carelessness of this tack. (A 9-A 10).

Citing directly from the seminal case of *Donovan v. Cunningham*, 716 F.2d 1455, 1474 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251, 104 S.Ct. 3533 (1984) the Ninth Circuit correctly concluded that "[a]n independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to insure their responsibilities are fulfilled. It is a tool and, like all tools, is useful only if used properly." (A 11)

The present status of the case is that the correct fiduciary standard ("the highest known to the law") was applied by the Ninth Circuit, which conforms with all other circuits, and conclusively demonstrates the breach of duty by the conflicted fiduciaries.

THE PROPER STANDARD TO MEASURE A FIDUCIARY'S CONDUCT IS SET FORTH IN ERISA AND WELL ESTABLISHED TRUST LAW

Congress adopted ERISA's fiduciary rules from the common law of trust with the instructions that these rules are to be interpreted "bearing in mind the special nature and purpose of employee benefit plans." (H.R. Rep. No. 93-

1280, 93rd Cong. 2d Sess., Reprinted in 1974 U.S. Code Cong. & Ad. News at 5083.) In accord with this legislative history are the Supreme Court cases of *Firestone Tire & Rubber Company v. Bruch*, 489 U.S. 101, 110-11, 109 S.Ct. 948, 954 (1989) [in determining the proper standard of court review for benefit denials, "we are guided by principles of trust law"] and *Central States v. Central Transport, Inc.*, 472 U.S. 559, 570, 105 S.Ct. 2833, 2840 (1985) ["[R]ather than explicitly enumerating *all* of the powers and duties of trustees and other fiduciaries, Congress invoked the common law of trusts to define the general scope of their authority and responsibility."]. *Howe v. Varity Corporation*, 36 F.3d 746 (8th Cir. 1994) *cert. granted, affirmed, Varity v. Howe* ___ U.S. ___, 115 S.Ct. 1793 (1995) agrees with Justice Brennan's concurring opinion in *Massachusetts Mutual Life Ins. Co. v. Russell*, 473 U.S. 134, 105 S.Ct. 3085 (1985) in which Justice Brennan found that ERISA was intended to incorporate the law of trusts.

Even before the United States Supreme Court decisions, the Ninth Circuit found: "[c]ourts have also recognized that in enacting ERISA, Congress made more exacting the requirements of the common law of trusts relating to employee benefit trust funds". *Donovan v. Mazzola*, 716 F.2d 1226, 1231 (9th Cir. 1983), *cert. denied* 464 U.S. 1040, 104 S.Ct. 704 (1984) citing *Sinai Hospital of Baltimore v. National Benefit Fund for Hospital &*

Health Care Employees, 697 F.2d 562, 565 (4th Cir. 1982).[1]

In deciding in favor of the defendant fiduciaries, the district court stated that it was utilizing the "business judgment rule". (A 7, A 9, D 9 No. 8, E 27) The "business judgment rule" reflects an inquiry into the subjective "good faith" of the officers of the corporation, and "exist(s) to protect and promote the full and free exercise of the power of management given to the directors." Fletcher Cyc. Corp. § 1039 (Perm. Ed.) Under the "business judgment rule" the officers and directors are generally not liable for "mere mistakes or errors of judgment, either of law or fact." Id. This is true even where the errors may be so gross "that they demonstrate the unfitness of the directors to manage the corporate affairs." *Id.*

The test imposed by ERISA's prudent person rule does not focus on the fiduciaries' subjective good faith but

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[1] The lower court's decision is at odds with the following pertinent circuit authority. *See Donovan v. Cunningham*, 716 F.2d 1455, 1464 n.15 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251, 104 S.Ct. 3533 (1984) ["ERISA's modifications of existing trust law include imposition of duties upon a broader class of fiduciaries, prohibition of exculpatory clauses, broad disclosure and reporting requirements, and nationwide uniformity of rules." (Citations omitted.)]; *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8 (2d Cir. 1982) *cert. denied*, 459 U.S. 1069, 103 S.Ct. 488 (1982) [the fiduciary obligations of ERISA are the "highest known to the law."] Accord, *Biggers v. Wittek Industries, Inc.*, 4 F.3d 291, 295 (4th Cir. 1993); *Warren v. Society National Bank*, 905 F.2d 975, 979-81 (6th Cir. 1990); *Leigh v. Engle*, 727 F.2d 113, 122-23 (7th Cir. 1984); *Eaves v. Penn*, 587 F.2d 453, 457 (10th Cir. 1978); *Fink v. National Savings and Trust Co.*, 772 F.2d 951, 955 (D.C. Cir. 1985). See, also *Deibler v. United Food and Commercial Workers' Local Union* 23, 973 F.2d 206, 210 (3d Cir. 1992) [relying on trust law principles].

plainly relies on external, objective standards of conduct which incorporate a process by which a fiduciary actually evaluates an investment. Unlike the business judgment rule, under ERISA's prudent standard a fiduciary may not simply rely on the advice of others. As the court noted in *Whitfield v. Cohen* 682 F.Supp. 188 (S.D.N.Y. 1988):

> While a trustee has a duty to seek independent advice where he lacks the requisite, education, experience, and skill, (citations omitted) the trustee, nevertheless, must make his own decision based on that advice. *Whitfield* 682 F.Supp. at 194

The trustee's obligation is aptly summarized in *Litchfield v. White* 7 N.Y. 438 (1852):

> The diligence of a provident man therefore is the measure of a trustee's duty. If it were otherwise, there would be one rule for a careless, and a different rule for a vigilant trustee; and a careless trustee would be exonerated in the same case in which the vigilant would be held liable. This was never intended, either by the elementary writers or by the authorities from which they deduce these conclusions. *Litchfield* 7 N.Y. at 443-44

29 U.S.C. § 1104 (ERISA § 404) and 29 U.S.C. § 1106 (ERISA § 406) prohibit transactions when there is a conflict of interest. While there are exceptions provided in 29 U.S.C. § 1108 (ERISA § 408), they are not applicable here. There can be no clearer conflict than when the purchaser controls the livelihood of the fiduciaries who agree to sell the stock for as little as they can get away with. "In short, the fiduciary provisions of ERISA were designed to prevent a trustee 'from being put into a position

where he has dual loyalties, and, therefore, he cannot act exclusively for the benefit of a plan's participants and beneficiaries.' H.R. Conf. Rep. No. 93-1280, *supra*, at 309, U.S. Code Cong. & Admin. News 1974 p.5089" *N.L.R.B. v. AMAX Coal Company*, 453 U.S. 322, 334, 101 S.Ct. 2789, 2796, (1981).

> This rule [ERISA § 406] both assures protection to plan beneficiaries and provides notice to plan fiduciaries of their obligations. It protects beneficiaries by prohibiting transactions tainted by a conflict of interest and thus highly susceptible to self-dealing. It gives notice to fiduciaries that they must either avoid the transactions described in Section 406(b) *or cease serving in their capacity as fiduciaries, no matter how sincerely they may believe that such transactions will benefit the plan.* Such protection of beneficiaries and notice to fiduciaries requires that Section 406(b) be broadly construed (citation omitted) and that liability be imposed even where there is "no taint of scandal, no hint of self-dealing, no trace of bad faith." *Cutaiar v. Marshall*, 590 F.2d 523, 528 (3d Cir. 1979), . . . *Lowen v. Tower Asset Management, Inc.*, 829 F.2d 1209, 1213 (2nd Cir. 1987). (Emphasis added.)

In this case it is impossible to assert there is "no taint of scandal, no hint of self-dealing, no trace of bad faith" when the ESOP's only asset was sold for $.17 on the appraised value dollar to the controlling shareholder of the corporation who held in his hands the economic well-being of the fiduciaries who voted to sell him the stock.

> Although officers of a corporation who are trustees of its pension plan do not violate their duties as trustees by taking action which, *after careful and impartial investigation*, they reasonably conclude best to promote the interests of participants and beneficiaries simply because it incidentally benefits the corporation or, indeed, themselves, their decisions must be made with an eye single to the interests of the participants and beneficiaries. (Citation omitted.) *This, in turn, imposes a duty on the trustees to avoid placing themselves in a position where their acts as officers or directors of the corporation will prevent their functioning with the complete loyalty to participants demanded of them as trustees of a pension plan. Donovan v. Bierwirth*, 680 F.2d 263, 271 (2nd Cir. 1982). (Emphasis added.) See also, *Burud v. Acme Electric Company, Inc.*, 591 F.Supp. 238, 247 (D.Ala. 1984).

The duty of undivided and complete loyalty to the plan participants and beneficiaries requires fiduciaries ". . . to step aside in favor of a neutral referee, or at the least, to conduct an explicit inquiry into the potential for a conflict of interest." *McMahon v. McDowell*, 794 F.2d 100, 110 (3rd Cir. 1986).

> As a practical matter, we view favorably the suggestion of the Secretary of Labor, as *amicus curiae*, that the preferred course of action for a fiduciary of a plan holding or acquiring stock of a target, who is also an officer, director or employee of a party-in-

> interest seeking to acquire or retain control, is to resign and clear the way for the appointment of a genuinely neutral trustee to manage the assets involved in the control contest. Otherwise, the risk is too great that the trustee will come to a crossroads where the interests of the plan and the party-in-interest diverge. *Leigh v. Engle*, 727 F.2d 113, 132 (7th Cir. 1984).[2]

The decision that Shay would remain a fiduciary was a corporate decision. Lehrer admitted that he did not even have the capacity to determine if he had a conflict of interest. (RT:II:162:20) Smith never even considered the issue. (RT:IV:128:14-24; 176:23-177:1, V:30:9-21)

It is undisputed that defendants decided that an independent fiduciary was not necessary. The only stated reason for such a decision was that it would cost between $50,000 and $100,000 to have an independent fiduciary, i.e., 1% to 2% of the heavily discounted price paid for the stock by the Shay defendants. Obviously, this was a small

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[2] In sharp contrast to this unequivocal standard is the *Howard* trial court's finding that: "Where a controversial choice by an employer-fiduciary would advance the employer's interest, a literal application of the exclusive benefit rule does appear to mandate resignation of the fiduciary. Sometimes this is appropriate. See, *Schwartz v. Interfaith Medical Center*, 715 F.Supp. 1190 (E.D.N.Y. 1989). But courts understandably conclude that such an extreme requirement often constitutes overkill and is not always appropriate. Any workable rule must take into account the nature of decision making and the virtual inevitability of complex motives. The first step is to decide when fiduciary action on mixed motives (whether or not by an employer-fiduciary) should be treated as wrong. On that basis pragmatic standards may be developed for identifying violations." (E 22) Judge Dickran Tevrizian was wrong, causing reversible error.

price to pay to assure the retirement benefits of over 800 people placing no burden on a company valued at $83,000,000.

ALL CIRCUITS AGREE THAT THE TRUST LAW MODEL IS THE PROPER MEASURE OF FIDUCIARY DUTY

The petitioners attempt to artificially create a conflict to satisfy U.S.S.C. Rule 10, citing *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984) and *Eyler v. C.I.R.*, 88 F.3d 445 (7th Cir. 1996). They argue that the mechanical steps taken by the fiduciaries of securing an appraisal somehow shields them from liability. They boldly assert that the only fiduciary requirements to which they should be held are that they provide appropriate information to a valuator and accept that valuator's result without an independent investigation. Such a mechanical approach has never been sanctioned by any court and should not even be considered for review by this court. No reasonable fiduciary looking to the beneficiaries protection could ever assert such a grotesque distortion of ERISA's legislative intent.

Indeed, this court in *Firestone Tire & Rubber Company v. Bruch*, 489 U.S. 101, 109 S.Ct. 948 (1989) confirmed that ERISA was created for the benefit of plan participants and beneficiaries in order to regulate, not benefit or protect, fiduciaries (*Firestone*, 489 U.S. at 113-114, 109 S.Ct. at 956; *Kim v. Fujikawa*, 871 F.2d 1427, 1433 (9th Cir. 1989)). Further, as stated in *Massachusetts Mutual Life Insurance Co. v. Russell*, 473 U.S. 134, 105 S.Ct. 3085 (1985):

> . . . [C]ourts must always bear in mind the ultimate consideration whether allowance or

> disallowance of particular relief would best effectuate the underlying purposes of ERISA - *enforcement of strict fiduciary standards* of care in the administration of all aspects of pension plans and promotion of the best interests of participants and beneficiaries. *Russell*, 473 U.S. at 158, 105 S. Ct. at 3098. (Brennan J. concurring.) (Emphasis added.)

Both the district court and the Ninth Circuit found that the fiduciaries *determined in advance* to accept the findings of AY, concluded in advance to sell the stock at the price set by AY without question, and sold the stock to one of their own based on the AY valuation. This was done without any inquiry as to the correctness of the methodology or even the result to be announced by AY. The entire transaction, and all participants to it, do not meet the letter of ERISA, nor the interpretation of its goals as articulated by this court.

Donovan v. Cunningham, supra, is absolutely consistent with ERISA fiduciary opinions in all of the circuits, and the United States Supreme Court. Although repeatedly cited as evidence of a conflict, that rhetoric is illusionary. At page 1474, the *Donovan* court found:

> *An independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled.* It is a tool and, like all tools, is useful only if used properly. *Donovan* 716 F.2d at 1474

> When a fiduciary has dual loyalties, . . . *the prudent person standard requires that he make a careful and impartial investigation of all investment decisions.* (Citation omitted.)

> Although Schaefer is not charged with making an improper investment decision, "[a] review of a fiduciary's independent investigation is one of the well-established yardsticks against which courts have customarily tested fiduciary conduct for prudence." See *Donovan v. Bierwirth*, 538 F.Supp. 463, 470 (E.D.N.Y. 1981), modified 680 F.2d 263 (2d Cir.), *cert. denied*, 459 U.S. 1069, 103 S.Ct. 488, 74 L.Ed.2d 631 (1982). *Schaefer v. Arkansas Medical Society*, 853 F.2d 1487, 1492 (8th Cir. 1988). (Emphasis added.)

The holding of *Cunningham* and the cases upon which it relies make it clear that a fiduciary must make an independent investigation and analysis of a proposed transaction in order to properly protect his charges and carry out his solemn duty. What the petitioners seek *is* a magic wand blessing a fatally flawed transaction which endorses their breach of duty of independent investigation and decision.

Eyler v. C.I.R., 88 F.3d 445 (7th Cir. 1996) is even more instructive and is in complete harmony with the Ninth Circuit's decision. The Commissioner of the Internal Revenue sought to impose an excise tax on an ESOP transaction in which the majority shareholders engaged in a prohibited transaction. In determining what was adequate consideration, the fiduciaries relied on a valuation done by Pru-Bache in conjunction with a failed proposed IPO, and relied on experts to argue the adequacy of the consideration. The tax court rejected both arguments, finding that the fiduciary did not meet his burden of establishing that the $14.50 per share price was fair market value of the stock. In the absence of the ESOP receiving adequate

consideration, the sale was a prohibited transaction. On appeal, the circuit court found that the Board members knew that many of the assumptions underlying the Pru-Bache price range were erroneous, and did nothing further to investigate the suggested price. Their actions did not rise to the level of prudence imposed on ERISA fiduciaries:

> In sum, the law requires a fiduciary of an ESOP to act with the care, skill, and diligence that a prudent person would undertake in acting on behalf of ESOP beneficiaries. The degree to which a fiduciary makes an independent inquiry is critical. We find no merit to Eyler's contention that the board of directors was well-informed and, therefore, made a good faith determination of the fair market value of the stock. The record does not show that even one director, let alone a majority, sought independent information on the fair market value of the stock. Rather, on the same day the project was presented, the board voted to guarantee a $10 million loan, the proceeds of which would be used to buy the majority shareholder's stock. *Eyler*, 88 F.3d at 456

Eyler and *Howard* present analogous facts, with both circuit courts condemning the conduct of the fiduciaries.

The petitioners also suggest that there is a conflict between the circuits regarding when a fiduciary may rely on experts. This position is asserted without benefit of any case authority.

In *Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983), *cert. denied* 104 S.Ct. 704 (1984), the court rejected a defense based reliance on advice of counsel as follows:

> Even if such advice had been received, reliance on counsel's advice, without more, cannot be a complete defense to an imprudence charge. (Citation omitted.) 716 F.2d at 1234.

In *Bidwell v. Garvey*, 743 F.Supp. 393 (D.Md. 1990) the court determined that the management fiduciaries reliance upon counsel for management did not constitute independent investigation or advice sufficient to justify the fiduciaries reliance. *Eyler v. C.I.R.*, *supra*, rejected the reliance upon advice of "experts" and reaffirmed decisions holding that seeking the advice of experts, without further investigation, violated ERISA's fiduciary standards.[3]

Note the circular nature of the petitioners' reasoning. AY expressly relied upon PAE, which relied upon AY, which relied on PAE!

The amicus brief of the governmental agency charged with enforcement of ERISA was sharply critical of petitioners' view on appeal and sets forth the opinion of the Department of Labor. The opinion is authoritative and persuasive in determining the Agency's interpretation of the law and regulations. In *Bartling v. Fruehauf Corp.* 29 F.3d 1062 (6th Cir. 1994), the court observed:

> [W]e are obliged to accord great deference to DOL interpretations. *Blessitt v. Retirement Plan for Employees of Dixie Engine Co.*, 848 F.2d 1164, 1167 (11th Cir. 1988); *see also Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844, 104 S.Ct. 2778, 2782, 81

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[3] *Reich v. Valley Nat. Bank of Arizona*, 837 F.Supp. 1259 (S.D. N.Y. 1993); *Donovan v. Mazzola*, 716 F.2d 1226 (9th Cir. 1983).

L.Ed.2d 694 (1984) ("[A] court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.") *Bartling* 29 F.3d at 1072

The DOL's position is that mere reliance on experts *fails to discharge fiduciary duties.*

APPLICATION OF STATE SECURITIES LAWS SUCH AS CALIFORNIA CORPORATION CODE § 1800 IS CONSISTENT IN THE CIRCUITS

Without dissent and relegated to a footnote was the circuit court's dismissal of petitioners' contention that ERISA pre-empts state security laws (here, Cal. Corp. Code § 1800), citing *Aloha Airlines, Inc. v. Ahue*, 12 F.3d 1498 (9th Cir. 1993). Using a tortured analysis, the petitioners contend that this holding is in conflict with *Sommers Drug Stores v. Corrigan Enterprises, Inc.*, 793 F.2d 1456 (5th Cir. 1986) and *McCallum v. Rosen's Diversified, Inc.*, 41 F.3d 1239 (8th Cir. 1994). Neither case stands for the proposition cited by petitioners.

The pre-emption issue has been decided by the United States Supreme Court in *N.Y. State Conference of Blue Cross & Blue Shield Plans v. Travelers Insurance*, __ U.S. __, 115 S.Ct. 1671 (1995). The State of New York had enacted provisions for surcharges on bills of patients whose insurance was obtained by employee health care plans governed by ERISA, and for surcharges on HMOs insofar as their membership fees were paid by an ERISA plan. The court held that these differing provisions for surcharges do not "relate to" employee benefit plans within the meaning of ERISA's pre-emption provision, 29 U.S.C. § 1144(a) (ERISA § 514(a)), and accordingly, are not pre-

empted. The court observed:

> . . . we have never assumed lightly that Congress has derogated state regulation, but instead have addressed claims of pre-emption with the starting presumption that Congress does not intend to supplant state law. *N.Y. State Conference* 115 S.Ct. at 1676

The court reaffirmed that to read any law that indirectly relates to an ERISA plan as being pre-empted would effectively read the limiting language of § 514(a) out of the statute, a conclusion that would violate basic principles of statutory interpretation and could not be squared with prior decisions of the court.

California Corporations Code § 1800 provides that a minority shareholder in a closely held corporation (less than 35 shareholders) may seek involuntary dissolution of the corporation and obtain a court ordered liquidation of its assets if "it is reasonably necessary to protect the shareholders' interest." It is not disputed by the petitioners that this is a valuable property right of a minority shareholder in California, whether ESOP or not. When a minority shareholder petitions for liquidation under § 1800, California Corporations Code § 2000 provides that the holders of 50% or more of the voting power of the corporation may avoid the dissolution of the corporation by purchasing for cash the shares owned by the minority shareholders at fair value. Section 2000(a) defines fair value:

> The fair value shall be determined on the basis of the liquidation value as of the valuation date but taking into account the possibility, if any, of sale of the entire business as a going concern in a liquidation. *Id.*

Taking the premise that liquidation value cannot be the fair market value (an unsupportable premise), petitioners argue for pre-emption.

> ERISA § 514(b)(2)(A) specifically holds:
> - - - [N]othing in this title shall be construed to exempt or relieve any person from any law of any State which regulates insurance, banking or securities.

Petitioners cite *Ft. Halifax Packing Co. v. Coyne*, 482 U.S. 1, 107 S.Ct. 2211 (1987) as an example that Congress intended national standards for all fiduciaries. Petitioners fail to advise this court that the holding of *Ft. Halifax*, *supra*, is totally inapposite to that position. A Maine state statute required employers to provide a one time severance payment to employees in the event of a plant closing. Not wanting to pay those benefits, *Ft. Halifax* argued that any state law pertaining to a type of employee benefits listed in ERISA necessarily regulates an employee benefit plan, and therefore must be pre-empted. *Ft. Halifax* argued that ERISA foreclosed virtually all state legislation regarding employee benefits. Justice Brennan, writing for the majority of this court (in a section immediately following petitioners' quote, but omitted) stated:

> The purposes of ERISA's pre-emption provision make clear that the Maine statute in no way raises the types of concerns that prompted pre-emption. Congress intended pre-emption to afford employers the advantages of a uniform set of administrative procedures governed by a single set of regulations. This concern only arises, however, with respect to benefits whose provision by nature requires an ongoing

> administrative program to meet the employer's obligation. It is for this reason that Congress pre-empted state laws relating to *plans*, rather than simply to *benefits*. Only a plan embodies a set of administrative practices vulnerable to the burden that would be imposed by a patchwork scheme of regulation. *Ft. Halifax* 482 U.S. at 11-12

Rather than supporting petitioners' position, *McCallum v. Rosen's Diversified, supra*, held that there was *no* pre-emption of a state securities statute:

> We conclude that section 751 does not relate to the employee benefit plan within the meaning of ERISA and, accordingly, ERISA will not serve to preempt appellant's Section 751 claim. *McCallum*, 41 F.3d at 1242

Similarly, *Sommers Drug Stores v. Corrigan Enterprises, Inc.*, 793 F.2d 1456 (5th Cir. 1986) held that ERISA did not pre-empt a state law breach of fiduciary duty. The Fifth Circuit reasoned that the state common law fiduciary duties centered upon the relationship between the corporate director and the shareholder. ERISA fiduciary duties, governing the relationship between the plan or planned beneficiaries are parallel but independent. *Sommers* held that a state's corporation law *was not pre-empted and could be used to prevent looting of a plan by the controlling shareholder.*

The argument asserted by petitioners (but not addressed by the Ninth Circuit) that there can be no reference to state law in valuation of stock owned by an ESOP is speculation, devoid of legal foundation. The cited cases of *Sommers* and *McCallum*, as well as *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 114 S.Ct. 1757

(1994) support the respondents and destroy the petitioners' assertion of conflict.

Had the fiduciaries conducted any independent investigation, they would have determined that pursuant to *Brown v. Allied Corrugated Box Co.*, 91 Cal.App.3d 477 (1979), discounts of the type used by AY to reduce the price that Shay would pay for the stock are inappropriate when the minority shareholder is being bought out by the controlling shareholder. Had the fiduciaries, AY, or its attorneys conducted an independent investigation, they would have also determined that the court in *Ronald v. 4-C's Electronic Packaging, Inc.* 168 Cal.App. 290 (1985), had rejected the minority discount when the minority shareholders invoke the protection of California Corporations Code §§ 1800 and 2000. They would have also found that under *Stumpf v. C.E. Stumpf & Sons, Inc.*, 47 Cal.App.3d 230 (1975), the corporation could be dissolved without grounds and without a showing of mismanagement when required to show fairness to the minority shareholders. See also *Charland v. County View Golf Club, Inc.*, 588 A.2d 609 (R.I. 1991).

NEITHER THE STANDARD OF REVIEW NOR THE VALUATION METHODS ARE PROPERLY BEFORE THE COURT

The monetary value of the stock is not an issue ripe for decision by this court. The Ninth Circuit determined that there was a breach of duty (A 7), that the so-called independent valuation of the stock was blindly accepted and never analyzed by the fiduciaries (A 10), and reversed and remanded the case for determination of damages to the district court (A 3). Having found as a matter of law that an improper standard was utilized by the trial court, it had

no occasion to determine whether or not the valuation was correct. That it viewed the result as suspicious based on the conduct of the fiduciaries and their controlling leash on AY is obvious.

Assuming that the questions raised by the Ninth Circuit concerning the AY evaluation are correct, the proper standard of review is set forth in *Long v. Flying Tiger Line, Inc.*, 994 F.2d 692, 694 (9th Cir. 1993) where the court held that it reviews the district court's "interpretation of ERISA, a federal statute, [as] a question of law subject to de novo review." (In accord, *Matter of McLinn* 739 F.2d 1395 (9th Cir. en banc 1984)). Cases cited by the petitioners on the standard of review do not stand for the proposition for which they are cited. *Citibank N.A. v. Wells Fargo Asia Ltd.*, 495 U.S. 660, 110 S.Ct. 2034 (1990) dealt with a pure factual determination, not an issue of law and fact. *Eyler v. C.I.R.*, *supra*, applied the only standard that a court can apply to a review of a tax court matter, i.e. whether or not the facts are clearly erroneous. *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981) did not discuss the standard of review whatsoever. There was a hypothetical rumination as to what the district court might have done, but there was no holding on the standard of review. *Estate of O'Connell v. C.I.R.*, 640 F.2d 249 (9th Cir. 1981) is once again a review of a tax court decision, where the clearly erroneous standard is singularly applied.

Perhaps the most egregious mis-citation is *Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996). Petitioners cite it for proof that the clearly erroneous standard is mandated. That court held at page 197:

> This appeal is taken from a final summary judgment predicated on stipulated facts and the district court's interpretation of a federal

statute, which we review *de novo*. *Id.*

Also in accord with de novo standard of review are *The Meadows v. Employers Health Ins.*, 47 F.3d 1006 (9th Cir. 1995) (reaffirming that de novo review is appropriate when the question is whether ERISA pre-empts state law), *Serrato v. John Hancock Life Ins. Co.*, 31 F.3d 882 (9th Cir. 1994) (confirming de novo review of the district court's interpretation and application of ERISA and determination that ERISA pre-empts certain state laws), and *St. Francis Regional Medical Center v. Blue Cross & Blue Shield of Kansas, Inc.*, 49 F.3d 1460 (10th Cir. 1995) (reaffirming de novo review of trial court's interpretation of ERISA).

By application of the law to the proper standard of review, the Ninth Circuit came to the correct conclusion, overturning the erroneous findings of the district court.

PETITIONERS' RELIANCE UPON THE *ESTATE OF BRIGHT* IS INAPPROPRIATE

Petitioners attempt to use *The Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. en banc, 1981) to argue that the Ninth Circuit overlooked the requirements of Revenue Ruling 59-60 and its impact on the valuation of the stock. Petitioners reliance on *The Estate of Bright* is misplaced, since the only issue addressed by the court was the value of the stock for estate tax purposes. In the instant case, the matter is irrelevant. As the en banc panel noted:

> The only issue facing the en banc court is whether the district court erred in entering the above-quoted pretrial order relating to the element of control. *Bright* 658 F.2d at 1000.

The pretrial order of the district court referred to provided,

in pertinent part:

> [N]o element of control can be attributed to the decedent in determining the value of the decedent's interest in the stock . . . for estate tax purposes. The parties are hereby ordered to proceed with preparation for trial and trial of this case on that basis. *Bright* 658 F.2d at 1000.

The portions of *Bright* relied upon by petitioners deal with the court's rejection of the government's arguments that what was transferred by the decedent was an "undivided one-half interest in the control block of 55% of the stock, and the second based on family attribution between the estate's stock interest and the stock interest held individually by Mr. Bright." (658 F.2d at 1000.) Thus, *Bright* does not stand for the proposition presented by petitioners.

Petitioners' motive in relying so heavily upon *Bright* is that, before the instant case, its 73% discount (658 F.2d 1008, fn.1) was the largest discount ever accepted by any court. (*See generally:* Appendix C to plaintiffs/appellants' Opening Brief filed in the circuit court.)

The futility of petitioners' arguments are easily dispelled by reference to the requirements of Revenue Ruling 59-60. While petitioners continuously recite the "willing buyer/willing seller test," Revenue Ruling 59-60 2.02 defines fair market value as " . . . the price at which the property would change hands between a willing buyer and a willing seller *when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. . . .* " (Emphasis added.) Fiduciaries who blindly accept the result of a valuation cannot be held to have reasonable knowledge of relevant

facts.

PAE is essentially a real estate holding company with net real estate assets of at least $78,000,000. Revenue Ruling 59-60, Section 5(b) states:

> The value of the stock of a closely-held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type, the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. (G 11-G 12)

The application of Revenue Ruling 59-60 to the valuation of the real estate assets owned by PAE mandates that the fiduciaries not accept an 87% discount on those assets.

While petitioners argue that the buyer and seller are hypothetical and must be considered in a vacuum, Revenue Ruling 59-60, Section 4.02(g) compels:

> Sales of stock of a closely held corporation should be carefully investigated to determine whether they represent transactions at arm's length. *Forced or distress sales do not ordinarily reflect fair market value nor do isolated sales in small amounts necessarily control as the measure of value.* (G 10)

Although *The Estate of Bright* court approved a 73% discount which petitioners so desperately seek in this case, Revenue Ruling 59-60 demonstrates the futility of their position and mandates return of this matter to the district court for a determination of damages.

CONCLUSION

Pursuant to United States Supreme Court Rule 10, petitioners' request for review on a Writ of Certiorari is meritless. Further, respondents fulfill their obligation under United States Supreme Court Rule 15 by pointing out the untimeliness of petitioners' arguments on methodology, valuation, or the ultimate fair market value of the stock transaction.

The conflicted fiduciaries absolutely breached all traditional notions of independence, fairness and rational financial reasoning. The Ninth Circuit was correct in its decision, both based on the law and the facts.

Respondents respectfully request that petitioners' request for review be promptly denied, and that the matter be remanded back to the district court for a

determination of damages that has been owed to this ESOP since 1988.

DATED: April 17, 1997

Respectfully submitted,
RAYMOND G. KOLTS
Counsel of Record

GARY C. NAWA
KATHLENE LANDGRAF KOLTS

KOLTS AND NAWA

Attorneys for Respondents
NEWMAN HOWARD, GILBERT LEON ALLEN, JOAN HOWARD and THEODORE H. POPE as representatives of plan participants similarly situated on behalf of THE EMPLOYEE STOCK OWNERSHIP PLAN OF PACIFIC ARCHITECTS AND ENGINEERS INCORPORATED

Supreme Court, U.S.
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No. 96-1580

IN THE

Supreme Court of the United States

OCTOBER TERM, 1996

EDWARD A. SHAY, MARTIN L. LEHRER, RICHARD L. SMITH, ALLEN E. SHAY, and PACIFIC ARCHITECTS AND ENGINEERS, INCORPORATED,
Petitioners,

vs.

NEWMAN HOWARD, GILBERT LEON ALLEN, JOAN HOWARD and THEODORE H. POPE as representatives of plan participants similarly situated on behalf of THE EMPLOYEE STOCK OWNERSHIP PLAN OF PACIFIC ARCHITECTS AND ENGINEERS INCORPORATED,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

PETITIONER'S REPLY BRIEF

LARRY R. FELDMAN
Counsel of Record

LESTER G. OSTROV

FOGEL, FELDMAN, OSTROV, RINGLER & KLEVENS

1620 26th Street, Suite 100 South
Santa Monica, California 90404-4040
(310) 453-6711

Attorneys for Petitioners

Lawyers Brief Service • Appellate Brief Printers • (213) 613-1013 • (714) 720-1510

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QUESTIONS PRESENTED

1. Do ERISA plan fiduciaries who have retained a qualified independent valuation expert, and who have provided all relevant, material information and who have not provided any false or misleading information to that expert, breach their fiduciary duties by relying upon the expertise and opinions of the valuation expert?

2. Do ERISA fiduciaries breach their fiduciary duties by failing to question valuation principles developed under Revenue Ruling 59-60 which have been judicially approved and by relying on a fair market valuation which has utilized such valuation principles?

3. In an ERISA valuation of stock do the "fair market value" requirements mandated by ERISA pre-empt state law "liquidation value" methodologies contained in corporate involuntary dissolution statutes or must an ERISA fair market valuation take into consideration such state law liquidation values?

4. Can a court of appeals reverse a trial court's decision that ERISA fiduciaries did not breach their fiduciary duties with respect to the sale of stock without reversing the trial court's findings of fact that the fiduciaries properly selected a qualified, independent valuation expert, that the fiduciaries provided all relevant, material information and no false or misleading information to the expert, and that the sale price was for fair market value, and without concluding that any of the trial court's findings of fact was clearly erroneous?

RULE 29.6 STATEMENT/PARTIES TO PROCEEDING

All parties in this Court appear in the caption of the case.

Pursuant to Rule 29.6, the Court is advised that petitioner Pacific Architects and Engineers, Incorporated is a closely-held company with no parent company, and no publicly traded stock. Other than wholly-owned subsidiaries, petitioner's only subsidiaries are The 1216 Corporation, PAE (New Zealand) Limited, PAE Bumi Berlian SDN BHD, K.K. Halifax Associates, Nus Antara Pacific Limited, JINDO-PAE Limited, P.T. Paranada Ekayasa, Pacific Architects and Engineers Company Limited, PAE-Middle East, Pacific Services Company Limited, and Far East Equipment Leasing Limited. None of the petitioner's non-wholly owned subsidiaries has issued stock to the public.

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II. The liquidation valuation methodologies of California's involuntary corporate dissolution statute, Cal. Corp. Code §1800, *et seq.*, may not be saved from preemption by ERISA under ERISA's "savings clause" for state statutes that regulate securities.

III. Review of the Ninth Circuit's application of the fundamental principles of valuation and of Federal Rule of Civil Procedure 52(b) is both necessary and proper by this Court because the Ninth Circuit's decision creates conflict with other Circuit Court decisions.

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I. The Ninth Circuit reversed the trial court's decision by introducing a wholly new standard of conduct for ERISA fiduciaries which is in conflict with the standard set forth by the Fifth and Seventh Circuits.

In order to avoid the conflict between the Ninth Circuit's decision in this case and the decisions of the Fifth and Seventh Circuits, Respondents assert that the Court of Appeals in this case merely "found as a matter of law that an improper standard was utilized by the trial court." Respondents' Opposition, p. 24. To the contrary, the Court of Appeals expressly stated that it did not base its opinion on whether the trial court utilized the proper standard. Instead the Court stated that, "we reverse on the grounds that even if the district court applied the prudent man standard, it did not apply it correctly." App. at A9.[1]

It is well-settled that an ERISA fiduciary must seek independent expert advice when the fiduciary lacks the requisite expertise, skill, or knowledge. *Katsaros v. Cody*, 744 F.2d 270, 279 (2d Cir.), *cert. denied*, 469 U.S. 1072 (1984); *Donovan v. Bierwirth*, 680 F.2d 263, 272-273 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982); *Donovan v. Walton*,

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[1]Respondents take out of context the trial court's "business judgment rule" language and distort its meaning. The trial court, as part of its analysis of whether the ESOP received "fair market value determined in good faith" addressed the fiduciary's business judgment which has been recognized as a necessary component of the "good faith" element required by ERISA § 1002(18)(B). *Donovan v. Cunningham*, 716 F.2d 1455, 1468 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984); Proposed 29 C.F.R. § 2510(b)(3)(ii) (53 Fed. Reg. 17632).

609 F.Supp. 1221, 1240 (D.C. Fla. 1985), *aff'd sub. nom., Brock v. Walton*, 794 F.2d 586 (11th Cir. 1986); 26 U.S.C. 401(a)(28)(C). Petitioner's first question presented raises the issue of then and under what circumstances an ERISA fiduciary can rely on that expert's advice.

The Ninth Circuit sets forth a new and extremely strict standard; one that very few ERISA fiduciaries could satisfy. It concludes that an ERISA fiduciary must be sufficiently knowledgeable with valuation techniques to review and question the methodology employed by the valuation expert and then, if there are any uncertainties, the fiduciary must retain at least a second valuation expert. App. at A11, A13. In direct conflict, the Fifth Circuit found that "ERISA fiduciaries need not become experts -- they are entitled to rely on the expertise of others" as long as the fiduciaries ensure that the valuation experts utilize complete and up-to-date information. *Cunningham, supra*, 716 F.2d at 1468. At the trial level, the District Court followed the Fifth Circuit's interpretation and application of ERISA's requirements, and yet this decision was reversed by the Ninth Circuit.

The Ninth Circuit's opinion does not simply reverse a trial court's erroneous choice of law as Respondents claim. Instead, the Court's decision fundamentally alters the standard of conduct required by ERISA fiduciaries, and the level of expertise which ERISA requires a fiduciary to possess, and is in direct conflict with the Fifth and Seventh Circuits' interpretation of ERISA's requirements. As Justice O'Scannlain noted in dissent, "I know of no case in which ERISA fiduciaries were adjudged to have breached their duty when they carefully selected and accurately informed the independent appraiser of the relevant data." App. at A12. The Ninth Circuit's decision in this case does just this.

II. The liquidation valuation methodologies of California's involuntary corporate dissolution statute, Cal. Corp. Code §1800, *et seq.*, may not be saved from preemption by ERISA under ERISA's "savings clause" for state statutes that regulate securities.

ERISA Section 2(18)(B) mandates that the value of a plan's assets must be determined by conducting valuation based on the assets' fair market value. 29 U.S.C. § 1002(18)(B). Further, this Court has consistently held that ERISA's preemption provisions create one of, if not the most, expansive preemption standards known to law. *California Division of Labor Standards Enforcement v. Dillingham Construction*, 65 U.S.L.W. 4097 (February 18, 1997) (see cases cited therein). Consequently, a state involuntary corporate dissolution statute which mandates that value be determined pursuant to a liquidation valuation must be preempted by ERISA's express fair market value requirements when conducting a valuation for ERISA purposes. The decisions of this Court, as well as the decisions of the Fifth and Eighth Circuits, require such a result. Consequently, the Ninth Circuit's decision in this case is in conflict with these decisions.

Respondents attempt to fundamentally change the Court of Appeals decision by stating (without citation) that "relegated to a footnote was the circuit court's dismissal of petitioners' contention that ERISA preempts state securities laws (here, Cal. Corp. Code § 1800), citing *Aloha Airlines, Inc. v. Ahue,* 12 F.3d 1498 (9th Cir. 1993)." Respondents' Brief, p. 19. Although the Respondents are correct that the Ninth Circuit's analysis of ERISA's preemption provision was primarily contained in a footnote, Respondents also attempt to transform the Ninth Circuit's decision into a decision based on ERISA's "savings clause" for state laws

which regulate securities.[2] However, Cal. Corp. Code § 1800 does not regulate securities, nor did the Court of Appeals base its decision on this ground.

California has a completely separate and distinct statutory framework that governs and regulates corporate securities under the Corporate Securities Law of 1968, Cal. Corp. Code §§ 25000, *et seq*. In contrast to the Corporate Securities Law of 1968, Cal. Corp. Code §1800 is an involuntary dissolution statute which sets forth the grounds which a corporation may involuntarily be forced in to dissolution, and how the assets of the corporation must be valued for dissolution purposes.[3]

The Sixth Circuit rejected arguments very similar to Respondents'. In *Michigan Carpenters Council v. C.J. Rogers, Inc.*, 933 F.2d 376 (6th Cir.), *cert. denied,* 502 U.S. 982 (1991), the Sixth Circuit addressed whether Michigan's corporate reorganization statute was preempted by ERISA,

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[2]ERISA's preemption "savings clause", 29 U.S.C. § 1144(b)(2)(A), provides: "Except as provided in subparagraph (B), nothing in this subchapter shall be construed to exempt or relieve any person from any law of any State which regulates insurance, banking, or securities."

[3]Respondents' claim that *Stumpf v. C.E. Stumpf & Sons, Inc.*, 47 Cal.App.3d 230 (1975), stands for the proposition that no grounds are required to invoke Cal. Corp. Code §1800 has no merit. In *Stumpf* the California Court of Appeals found that:

> "the procedure created by the statute does not authorize dissolution at will. The minority must persuade the court that fairness requires drastic relief under section 4651, subdivision (f) [the predecessor statute to Section 1800(b)(5)]; involuntary dissolution is not an automatic remedy but, rather, a matter for the court's discretion." *Id.* at 235.

and whether the statute "regulated securities" as defined by ERISA's preemption "savings clause," 29 U.S.C. § 1144(b)(2)(A). The Sixth Circuit noted that Michigan has a separate and distinct state securities act and that the reorganization statute concerned general corporate governance, not the regulation of securities. *Id.*, at 384. Thus, the Michigan corporate reorganization statute did not fall within ERISA's "savings clause." As a result, unlike the Ninth Circuit in this case, the Sixth Circuit found that the Michigan reorganization statute was preempted by ERISA to the extent it interfered with the calculation of benefits, disbursement and availability of funds. *Id.*, at 383.[4]

Furthermore, the Ninth Circuit's opinion does not even base its conclusions on ERISA's savings clause for securities regulations, 29 U.S.C. § 1144(b)(2)(A). The Court of Appeals decision does not even make reference to ERISA's savings clause, nor in any way characterize Section 1800 as a securities regulation. Indeed, the case law cited by the Ninth Circuit, *Aloha Airlines v. Ahue,* 12 F.3d 1498 (9th Cir. 1993), does not even concern ERISA's "savings clause" provision for state statutes which regulate securities. Consequently, Respondents' attempt to buttress the Ninth Circuit's legal conclusion that ERISA's fair market value

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[4]Respondents, as well as the Ninth Circuit, seem to view ERISA preemption as an all or nothing issue. However, many courts have recognized that a state statute may be preempted only to the extent that the state statute may be used to effect change in the administration, structure and benefits of an ERISA plan. *See, e.g. National Elevator Indus., Inc. v. Calhoon*, 957 F.2d 1555, 1561 (10th Cir.), *cert. denied*, 506 U.S. 953, 113 S.Ct. 406 (1992); *Michigan Carpenters, supra*, 933 F.2d, at 382-383. Requiring liquidation value under Cal. Corp Code § 1800, *et seq.* to be incorporated into ERISA's fair market value requirements would do exactly this.

requirements do not preempt Cal. Corp. Code § 1800's liquidation valuation procedures based upon ERISA's securities laws savings clause is without any basis.

III. Review of the Ninth Circuit's application of the fundamental principles of valuation and of Federal Rule of Civil Procedure 52(b) is both necessary and proper by this Court because the Ninth Circuit's decision creates conflict with other Circuit Court decisions.

Contrary to Respondents' assertion that the Ninth Circuit "had no occasion to determine whether or not the valuation was correct," (Respondents' Opposition, p. 24), the Court's decision was premised on its attack of Arthur Young's valuation methodology. Respondents' claim to the contrary is disingenuous. The Court of Appeals sets forth what it perceived to be the problems with Arthur Young's valuation methodology by requiring the fiduciaries to question and challenge the problems that it perceived. The standard to which the Court held the fiduciaries is inextricably intertwined with the valuation methodology utilized by Arthur Young which the Court concluded should have been questioned by the fiduciaries.

In this manner, the Court of Appeals challenged three key aspects of Arthur Young's valuation methodology: the size of the minority discount, the liquidity discount, and the marketability discount that were applied by Arthur Young (App. at A9-A11).[5]

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[5]The Court of Appeals states, with regard to the liquidity discount, "[a]lthough it gave reasons for deviating from the average, Arthur Young did not explain why these reasons resulted in an increase of fifteen percentage points as opposed to some lesser amount." App. at A10. With regard to the minority

The Court of Appeals squarely addresses the factual basis for the District Court's decision, yet never addresses whether any of the District Court's findings of fact were clearly erroneous. Additionally, the Court of Appeals addresses neither the evidence presented at trial, nor gives any credence to the trial court's assessment of the credibility of the witnesses presented at trial.[6] Further, almost every case which has addressed issues of valuation has found that the value of stock is a question of fact, to be reviewed under a clearly erroneous standard. Respondents' citations to cases involving appellate review of preemption issues is misplaced. The issue presented to this Court regarding the proper standard of review involves the valuation of the stock, not preemption.

IV. The standard of review utilized by the Ninth Circuit directly conflicts with decisions of the Fifth and Seventh Circuits.

Again, to avoid the conflict created by the Ninth

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discount, the Court stated that Arthur Young applied the discount, "without providing any empirical support for a 60% discount or giving any explanation as to why it increased this discount factor twenty percentage points since its May valuation." Id.

[6]The District Court expressly rejected the Plaintiffs/Respondents' arguments concerning Arthur Young's valuation because, as the District Court found:

> "At trial, defendants' witnesses, both percipient and expert, clearly articulated the propriety and reasoning for each of the discounts taken. Plaintiff's experts on the other hand were not able to articulate any logical or legal reason for disallowing the discounts taken by Arthur Young & Company." App. at E11.

Circuit's decision with the Fifth and Seventh Circuits concerning the proper standard of review for questions of the value of closely-held corporate stock, Respondents attempt to buttress the Ninth Circuit's decision by supplementing the Court's reasoning and by asserting facts that are contrary to the record and in conflict with the findings of fact of the District Court -- findings not reversed by the Court of Appeals.

Respondents assert that "[b]y application of the law to the proper standard of review, the Ninth Circuit came to the correct conclusion, overturning the erroneous findings of the district court." Respondents' Opposition, p. 25. Quite to the contrary, the Court of Appeals never states the standard of review it has utilized. Additionally, the Court of Appeals neither reverses nor finds clearly erroneous any of the District Court's findings of fact.

Nevertheless, Respondents continue to attempt to reargue the facts of this case in direct conflict with the District Court's findings. For example, Respondents contend that the main purpose of the 1988 stock sale was for estate planning purposes.[7] However, the District Court expressly found that the "continued liquidity of the ESOP and the possible future inability to purchase shares from plan participants and beneficiaries were the prime reasons the plan fiduciaries voted to sell the PAE stock to the E. & A. Shay Irrevocable Trust on November 9, 1988." App. at D7.

The District Court also expressly found that the fiduciaries properly retained Arthur Young. App. at D5. Respondents attempt to characterize the fiduciaries search as somehow tainted. Yet, the District Court found that

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[7]Respondents state, "The district court record reveals that the purpose of the termination of the ESOP was part of Shay's estate planning for his son, co-defendant, Allen Shay (Ex. 31; 47, 50; RT: IV:58:8-59:17)."

"[f]ollowing extensive interviews of major valuation firms, Arthur Young & Company was retained by the administrative committee of PAE ESOP. . ." and that the fiduciaries "provided all relevant, material information to Arthur Young & Company regarding the ESOP and PAE's assets and operations and did not provide any false or misleading information to Arthur Young & Company. App. at D5.[8]

Additionally, Respondents assert that Arthur Young & Company relied on PAE's attorney and that regular counsel to the ESOP was never even consulted on the issue of whether there were grounds to invoke Cal. Corp. Code § 1800. Respondent's Opposition, p. 4-5. To the contrary, the ESOP's regular counsel, Ronald Ludwig, as well as PAE's corporate attorney, Carol May, both testified that Mr. Ludwig was consulted and that he was satisfied that the ESOP had no grounds to commence involuntary dissolution proceedings against PAE. *See* IX/109:12-13; XVI/29:18-30:17, 53:21-54:9.[9] Since the Court of Appeals did not reverse any of the

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[8]Moreover, the record in this case does not support Respondents' charge that the fiduciaries decided in advance to accept a predetermined appraisal. Respondents' Opposition, p. 2. At trial, Petitioner Richard Smith testified that the fiduciaries did not set a certain price. XVII:153:4-8. Additionally, Smith testified that he had received a preliminary valuation figure from Arthur Young and Company in October 1988 which was lower than the eventual sale price and he refused to even consider the sale at this price because he felt that it was too low. XVII:154:23-155:24.

[9]Indeed even the portion of the transcript immediately preceding the portion cited by Respondents evidences Mr. Ludwig was consulted. *See* II:128:13-19 ("Q [by Mr. Kolts]: Had you discussed that subject matter with anyone before receipt of this letter? A [by Mr. Lehrer]: There had been some previous discussion on this, and it was the opinion of the administrator, Mr. Smith, and the counsel for the ESOP, Mr. Ron Ludwig, that there

District Court's findings of fact, this Court should not countenance Respondents' attempts to distort the facts at this stage.

V. CONCLUSION

For all of the foregoing reasons, the petition should be granted.

DATED: April 25, 1997

Respectfully Submitted,
LARRY R. FELDMAN
Counsel of Record

LESTER G. OSTROV

FOGEL, FELDMAN, OSTROV, RINGLER & KLEVENS

Attorneys for Petitioners
Edward A. Shay, Martin L. Lehrer, Richard L. Smith, Allen E. Shay, and Pacific Architects and Engineers, Incorporated

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were no facts that would provide grounds for involuntary dissolution.")

No. 96-1580

(4)

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1996

EDWARD A. SHAY, MARTIN L. LEHRER, RICHARD L. SMITH, ALLEN E. SHAY, and PACIFIC ARCHITECTS AND ENGINEERS, INCORPORATED,

Petitioners,

vs.

NEWMAN HOWARD, GILBERT LEON ALLEN, JOAN HOWARD and THEODORE H. POPE as representatives of plan participants similarly situated on behalf of THE EMPLOYEE STOCK OWNERSHIP PLAN OF PACIFIC ARCHITECTS AND ENGINEERS INCORPORATED,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

MOTION FOR LEAVE TO FILE AND BRIEF OF CROWLEY MARITIME CORPORATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

CAMERON W. WOLFE, JR.
Counsel of Record

PAUL C. BORDEN
ORRICK, HERRINGTON & SUTCLIFFE LLP
400 Sansome Street
San Francisco, CA 94111
(415) 392-1122

Attorneys for Amicus Curiae Crowley Maritime Corporation

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

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MOTION FOR LEAVE TO FILE AS AMICUS CURIAE IN SUPPORT OF PETITIONER

Pursuant to Rule 37.2 of the Rules of this Court, *amicus*, Crowley Maritime Corporation ("Crowley"), respectfully moves this Court for leave to file the attached Brief as *Amicus Curiae* in Support of the Petition for Writ of Certiorari. The consent of the attorney for the Petitioners herein has been obtained, but the attorney for the Respondents herein has refused to consent to the filing of a brief by Crowley as *amicus curiae*.

The applicant, Crowley, is a closely held corporation that has tentatively approved the adoption of a stock savings plan that stands to benefit its employees. As a closely held corporation, Crowley shares a concern in the significant burden that the Ninth Circuit's decision imposes on fiduciaries who are not themselves professional valuators of closely-held stock.

If the stock savings plan is implemented, annual valuations of Crowley common stock will be required for routine annual transactions such as the purchase of shares of capital stock, possibly both from majority and minority shareholders of the company, as well as from retiring participants. Valuations would also be required if other, less routine transactions involving shares of capital stock were to occur. The Board of Directors, each of whom would become a fiduciary under ERISA if the stock savings plan is implemented, consists of only one employee of Crowley and a number of outside directors. None of the directors has expertise in the valuation of closely-held shares of capital stock. Crowley is concerned that the Ninth Circuit's decision in this case will make it

difficult for Crowley to retain and attract qualified directors with business experience at a high level.

Crowley submits that the decision of the Ninth Circuit creates a conflict between the circuits regarding the required fiduciary duty of prudence under Section 404 of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") (29 U.S.C. § 1104). The issues relate to the sale of stock between an employee stock ownership plan or profit sharing plan and a party in interest when the sale must be for "adequate consideration" as defined in Section 3(18) of ERISA (29 U.S.C. § 1002(18)).

Crowley stands to be particularly affected by the decision below in its attempt to implement a stock savings plan. The issues presented by this case are of exceptional importance to Crowley in that Crowley seeks to be able to establish and operate an employee benefit plan utilizing employer stock in circumstances where its fiduciaries are subject to the same clearly identifiable standards of prudence and care applicable in the other circuits. Crowley's brief traces the body of law and administrative regulations that have developed under ERISA regarding prudent selection of expert advice and reliance on the advice of those experts in arriving at the value of a closely-held company. Crowley believes this discussion, focusing on the contexts of ERISA and closely-held companies, will be useful to the Court in addressing the issues presented. Crowley therefore

respectfully seeks leave of this Court to file the attached brief in support of the Petition for Writ of Certiorari.

Dated: April 29, 1997

Respectfully submitted,

CAMERON W. WOLFE, JR.
Counsel of Record

PAUL C. BORDEN
ORRICK, HERRINGTON & SUTCLIFFE LLP

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BRIEF OF CROWLEY MARITIME CORPORATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

PRELIMINARY STATEMENT

Crowley Maritime Corporation ("Crowley") submits this brief as *amicus curiae* in support of Petitioner in this proceeding. Respondents Newman Howard, Gilbert Leon Allen, Joan Howard and Theodore H. Pope as representatives of plan participants similarly situated on behalf of the employee stock ownership of Pacific Architects and Engineers Incorporated, ("Respondents") declined to consent to the filing of this brief. Accordingly, it is accompanied by a Motion for Leave to File As Amicus Curiae In Support of Petitioner.

INTEREST OF AMICUS CURIAE

Crowley is a diversified marine transportation company providing transportation services in domestic and international markets, employing more than 5,000 employees and more than 200 tugs, barges, roll-on/roll-off ships and container ships. Its principal executive offices are located at Oakland, California. A majority of shares of capital stock of Crowley are owned by members of the Crowley family, but, in addition there are approximately 123 public shareholders and an inactive employee benefit plan which continues to hold shares of capital stock. Such shares are not listed on a national securities exchange and there is no established public trading market for them, although quotations for shares of Crowley common stock may be obtained in the "pink sheets" or otherwise.

At its meeting on February 27, 1997 the Board of Directors of Crowley tentatively approved adoption of a new stock savings plan intended to instill in its employees pride of ownership in the company while providing them a form of deferred compensation and retirement benefits. It is contemplated the plan will qualify under Section 401(a) of the Internal Revenue Code as a profit sharing plan and that funds contributed to the

plan will be primarily invested in shares of common stock of Crowley. Depending on the resolution of issues such as those raised by the decision of the Ninth Circuit in this case, Crowley in the future may decide to limit the contributions it makes to a stock based plan or to consider curtailing it altogether.

If the stock savings plan is implemented, annual valuations of Crowley common stock will be required for routine annual transactions such as the purchase of shares of capital stock, possibly both from majority and minority shareholders of the company, as well as from retiring participants. Valuations would also be required if other, less routine transactions involving shares of capital stock were to occur. The members of the Board of Directors, each of whom would become a fiduciary under ERISA if the stock savings plan is implemented, consist of only one employee of Crowley and a number of outside directors. None of these directors has expertise in the valuation of stock. Crowley is concerned that the Ninth Circuit's decision in this case will make it difficult for Crowley to retain and attract qualified directors with business experience at a high level.

SUMMARY OF ARGUMENT

The Employee Retirement Income Security Act of 1974, as amended ("ERISA")[1] clearly permits an employer to engage in the purchase or sale of employer stock with a profit-sharing plan or an employee stock ownership plan ("ESOP") if certain conditions are met. Specifically, the sale of stock between an employee stock ownership plan or profit sharing plan and a party in interest is permitted if the sale or purchase is for "adequate consideration", as defined in Section 3(18) of ERISA (29 U.S.C. § 1002(18)), and if the sale or purchase is

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[1] Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of U.S.C.) (1974).

otherwise prudent under Section 404 of ERISA (29 U.S.C. § 1104).

Because the vast majority of individual fiduciaries are not experts in the valuation of closely-held companies, they principally rely on the advice of an independent valuator in prudently arriving at a price that meets the standards for "adequate consideration."

Crowley files this *amicus curiae* brief because the position of the Ninth Circuit Court of Appeals would make any establishment of a plan subject to ERISA that holds Crowley stock problematic to say the least, because the method for determining adequate consideration that is suggested by the Ninth Circuit is unclear and would not appear to work at a practical level. As a result, the Ninth Circuit Court's ruling would make it virtually impossible for the fiduciaries of Crowley's plans to know whether they have met their fiduciary duties whenever an issue arose concerning the valuation of Crowley stock.

Standing in contrast to the Ninth Circuit's decision is the substantial body of law developed since ERISA's enactment that permits, even requires, fiduciaries to rely on the advice of an expert in arriving at the value of a closely-held company. Until the Ninth Circuit decision came down, this body of law could have been relied upon by Crowley and virtually every other closely-held company that has established an ESOP or profit-sharing plan holding employer stock.

Because of the conflict between circuits created by the Ninth Circuit's decision, and the significant burden that its decision imposes on fiduciaries who are not themselves professional valuators of closely-held stock, Crowley urges this Court to grant the Petition for Certiorari in this case, and to reverse the erroneous holdings of the Ninth Circuit.

ARGUMENT

I. Petitioner Met The Requirements Of Prudence And Adequate Consideration Imposed By ERISA On Fiduciaries Who Authorize The Sale Of Company Stock From A Plan To A Party In Interest.

With one decision the Ninth Circuit has expanded beyond the limits set by any other court the expertise required of fiduciaries who act on behalf of plans that buy or sell stock of the employer sponsoring the plan. This expansion of personal liability to fiduciaries is not only unwise from a policy standpoint, since it will greatly discourage the implementation of employee benefit plans that Congress has sought to encourage, but also is clearly contrary to the case law developed in other circuits and to relevant statutes and regulations.

In the present case, even though Petitioners had selected and relied on the advice of an expert (Arthur Young & Company) in the determination of the value of the ESOP's company stock holdings, the Ninth Circuit found that such reliance did not meet the requirements of prudence and adequate consideration imposed by ERISA. The Ninth Circuit so held despite having no quarrel whatsoever with the selection of an independent and major accounting firm's valuation group and while recognizing that such firm was provided with all facts relevant to the making of the valuation in question. Instead, the Ninth Circuit held that Petitioners did not satisfy their duties under ERISA because they did not second-guess the application of certain discounts that Arthur Young had used to value the company stock held by the ESOP. Thus, the Ninth Circuit's opinion rests on its conclusion that fiduciaries must question the underlying methodology used by a competent independent valuator of closely-held stock.

Many employers rely in good faith on the advice of an independent valuator, exactly as Petitioners did, and

based on court decisions, revenue rulings and Proposed Regulations, have always assumed that their conduct was reasonable and within the law. Crowley was planning to do exactly that with its newly contemplated plan, but now the Ninth Circuit's ruling potentially subjects individual fiduciaries of ESOPs or other plans containing employer stock to personal liability for such behavior – notwithstanding that it was widely believed before now to be clearly in accordance with the adequate consideration standard and within the boundaries of what is considered prudent under ERISA.

The "prudence" requirement of ERISA is contained in ERISA § 404(a)(1) (29 U.S.C. § 1104(a)(1)) which provides, in relevant part, that a fiduciary must discharge its duties with respect to a plan:

> solely in the interest of the participants and beneficiaries and –
>
> . . .
>
> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. . . .

In regulations issued shortly after ERISA's enactment in 1974, the Department of Labor ("DOL") interpreted the prudence requirements of the statute quoted above and specifically allowed a fiduciary to rely on experts:

> A plan fiduciary may rely on information, data, statistics or analyses furnished by persons performing ministerial functions for the plan, provided that he has exercised prudence in the selection and retention of such persons. The plan fiduciary will be deemed to have acted prudently in such selection and retention if, in the exercise of ordinary care in such situation,

> he has no reason to doubt the competence, integrity or responsibility of such persons.

29 C.F.R. § 2509.75-8 FR-11 (1996).

While the regulations quoted above are general in scope, and so do not speak specifically to the issue of retaining an expert to value the stock of a closely-held company, they do clearly permit a fiduciary to rely on the analyses of non-fiduciaries, and specifically provide that the fiduciary has met its fiduciary duties if, in the exercise of ordinary care, it has no reason to doubt the competence, integrity or responsibility of the expert. Under ERISA Section 404's prudence requirement, a fiduciary retaining an expert is not required to second-guess the expert's analyses or reports; all that is required of the fiduciary under ERISA is prudently to select the expert and then monitor the expert, using ordinary[2] (not extraordinary) care to ensure that it has no reason to doubt the expert's competence, integrity or responsibility.

Parallel to the prudence rules described above are the prohibited transaction rules of ERISA, and the exceptions to those rules dealing directly with the issue of valuing stock in a closely-held company. ERISA Section 406 (29 U.S.C. § 1106) generally prohibits transactions between a plan and a "party in interest", such as Petitioners, but makes an exception under ERISA Section 408(e) (29 U.S.C. § 1108(e)) for the acquisition or sale by a plan of qualifying employer securities "if such acquisition [or] sale . . . is for adequate consideration," among other requirements not here relevant.

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[2] *See Donovan v. Cunningham*, 716 F.2d 1455, 1467 n.26 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984), rejecting the suggestion that ERISA's fiduciary standards requiring "a prudent man familiar with such matters" creates a "prudent expert" standard.

"Adequate consideration", in turn, is defined by ERISA Section 3(18) (29 U.S.C. § 1002(18)) in relevant part as:

> in the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary.

The Preamble to the Proposed Regulations issued by the DOL defining "adequate consideration" states that determining adequate consideration is a two-step process, (1) fair market value, and (2) good faith:

> First, the value assigned to an asset must reflect its fair market value as determined pursuant to proposed § 2510.3-18(b)(2). Second, the value assigned to an asset must be the product of a determination made by the fiduciary in good faith as defined in proposed § 2510.3-18(b)(3).

53 Fed. Reg. 17,633 (1988) (Preamble).

For purposes of the fair market value requirement in determining adequate consideration:

> "fair market value" . . . means the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well informed about the asset and the market for such asset.[3]

53 Fed. Reg. 17,637 (1988) (to be codified at 29 C.F.R. § 2510.3-18(b)(2)) (Proposed May 17, 1988).

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[3] This was the standard used by Arthur Young in its valuation of the stock in question.

In discussing the fair market value requirement just quoted, the Preamble strongly encourages fiduciaries to rely on experts when it states that "the extent to which the Department will view a valuation as reflecting fair market value will be affected by an assessment of the level of expertise demonstrated by the parties making the valuation". 53 Fed. Reg. 17,634 (1988) (Preamble).

After discussing the fair market value requirement, the Preamble discusses the good faith requirement that applies where the fiduciary itself makes the evaluation, and when an independent valuation should be obtained to meet that requirement:

> [T]his section states that either the fiduciary making the valuation must itself be independent of all the parties to the transaction (other than the plan), or the fiduciary must rely on the report of an appraiser who is independent of all the parties to the transaction (other than the plan).

53 Fed. Reg. 17,634 (Preamble).

Therefore, the Proposed Regulations under ERISA Section 3(18) actually *require* the fiduciary who is not independent to rely on the advice of an independent expert in determining adequate consideration ("the fiduciary making the valuation . . . *must rely on the report of an appraiser who is independent"*). Likewise, as demonstrated above, DOL regulations state that a fiduciary meets its prudence obligation under ERISA by relying on the analyses of a prudently retained expert.

Until now, the case law was in harmony with the regulations. That is because until the Ninth Circuit's decision, courts uniformly held that both the prudence requirement and the adequate consideration requirement under ERISA are met when a fiduciary responsible for valuing the stock of a closely-held company relies in good faith on the advice of an independent expert.

The case law strongly encourages fiduciaries who make difficult decisions on behalf of a plan, including decisions as to the value of company stock, to make use of the skills of an expert. *Katsaros v. Cody*, 744 F.2d 270 (2d Cir. 1984), *cert. denied, Cody v. Donovan*, 469 U.S. 1072 (1984) (trustees breached their duty in failing to seek outside expert); *Leigh v. Engle*, 727 F.2d 113 (7th Cir. 1984), *on remand*, 619 F. Supp. 154 (N.D. Ill. 1985), *and on remand*, 669 F. Supp. 1390 (N.D. Ill. 1987), *aff'd*, 858 F.2d 361 (7th Cir. 1988), *cert. denied, Johnson v. Engle*, 489 U.S. 1078 (1989) (fiduciary duties breached where administrators of profit sharing plan failed to seek independent advice before purchasing stock); *Ershick v. UMB*, 12 E.B.C. 2323 (D. Kans. 1990), *aff'd*, 948 F.2d 660 (10th Cir. 1991) (directed trustee's reliance on an independent appraiser to value company stock fully discharged its responsibility). Thus, in undertaking the sale or purchase of company stock on behalf of a plan, non-independent fiduciaries are required by regulations and the courts to hire and rely on experts, and failure to do so will result in fiduciary breach. Therefore, Petitioners' reliance on Arthur Young to value the stock is not only permitted, but appears to be required.

Of course, if a fiduciary attempted to influence the outcome of an expert's valuation report, a court could find inadequate consideration or fiduciary breach based on a lack of good faith. But where, as in the Ninth Circuit's decision here, the court does not find clearly erroneous the district court's holding that the sale of stock was conducted in good faith, a finding of fiduciary breach or lack of adequate consideration is virtually always limited to situations relating to the inadequate *factual basis* of the valuator's opinion and not, as the Ninth Circuit has held, to an analysis of the underlying methodology or discount rates by which the valuator arrived at the value.

The Ninth Circuit's ruling makes the requirement of relying on an expert rather meaningless, because it requires the fiduciary itself to have enough expertise to question the expert's methodology, the very skill that is admittedly within the expertise of the expert, and not within the knowledge of the fiduciary. How could a company such as Crowley qualify when it has no valuation experts on its Board? Are such companies precluded from having employer stock based employee benefit plans unless they put valuation experts on their boards? These are very real questions for Crowley. Is Crowley therefore precluded from having a stock-based benefit plan?

This is a very bad result given that the rule enunciated by the Ninth Circuit is simply not the rule contained in the statute or regulations. Prior to the decision of the Ninth Circuit, employers and practitioners alike widely believed *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984), to be the leading case in this area. In *Cunningham*, where ESOP fiduciaries were found to have breached their fiduciary duties by purchasing stock on behalf of the ESOP for more than adequate consideration, the court held that:

> ESOP fiduciaries will carry their burden to prove that adequate consideration was paid by showing that they arrived at their determination of fair market value by way of a prudent investigation in the circumstances then prevailing.

Id. at 1467-68 (footnote omitted).

The *circumstances* that the fiduciaries failed to investigate prudently in *Cunningham* were the *factual* bases underlying the valuation report:

> The insufficiency of appellees' investigation lies in their failure to identify the facts and assumptions underlying the Rotan Mosle appraisal and to consider whether they

> remained valid at the time of the ESOP transactions. Cursory study of Rotan Mosle's report would have shown that they did not in several material respects.
>
> . . . .
>
> To sum up, we hold that appellees Cunningham, Fritcher, Hairell, Robertson and Esparza failed to conduct an investigation sufficient to determine if the Rotan Mosle appraisal remained a reasonable approximation of the fair market value of MCS stock at the times they relied on it. Two critical assumptions made by Rotan Mosle – the growth projections and the absence of an ESOP – no longer were valid.

Id. at 1469-70 and 1473 (footnote omitted).

Most importantly, in demonstrating the direct conflict with the Ninth Circuit, the Fifth Circuit rejected the Deparment of Labor's attempt to obtain a ruling from the court that the fiduciaries breached their duties as the result of the discounts used by the valuator:

> The Secretary also urges us to hold that ESOP fiduciaries must always discount the appraised price of a controlling block of stock when less than control is acquired by the ESOP. The Secretary bases his discount argument upon Revenue Ruling 59-60 which sets out principles for valuing closely-held stock for estate and gift tax purposes. . . .
>
> Judicial adoption of this revenue ruling is no substitute for the regulations the Secretary has never promulgated; we are unwilling to hold that ERISA fiduciaries who fail to follow it jot and tittle have breached their duties. Appraisal of closely-held stock is a very inexact science; given the level of uncertainty inherent in the process and the variety of potential fact patterns, we do not think a court should require

> fiduciaries to follow a specific valuation approach as a matter of law under Section 3(18).

Id. at 1472-73 (footnotes omitted).

Like many cases before it, the Ninth Circuit quotes the "magic wand" passage from the *Cunningham* decision, but then inexplicably, and unlike any case before it, the Ninth Circuit totally disregards what *Cunningham* says in that passage. *Cunningham* holds that fiduciaries in stock valuation cases do have a duty – to make sure that the facts used by the valuator are complete, accurate and up to date, but they are not required to second-guess the methodology used by the valuator, and thus by relying on the expert are completely within the prudent performance of their fiduciary duties:

> The appraisal represented a quantitative analysis of specific facts and assumptions. Prudent fiduciaries would have sought to analyze the effect of obvious changes in those facts and assumptions – either by their own efforts or with the help of advisors. An independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled. It is a tool and, like all tools, is useful only if used properly. To use an independent appraisal properly, ERISA fiduciaries need not become experts in the valuation of closely-held stock – they are entitled to rely on the expertise of others. . . . However, as the source of the information upon which their experts' opinions are based, the fiduciaries are responsible for ensuring that that information is complete and up-to-date. In failing to do so, the appellees breached their duties of prudence under Section 404 and likewise cannot establish that they paid adequate consideration. Accordingly, the ESOP transactions also were prohibited by Section 406.

Id. at 1474.

Therefore, although obtaining the advice of an independent expert as to the valuation of closely-held company stock is not a complete defense to allegations of imprudence or lack of adequate consideration under ERISA, neither *Cunningham* nor any other case of which Crowley is aware, except the Ninth Circuit's recent decision, holds that good-faith reliance on the advice of an expert who was qualified to conduct an appraisal and who had complete, accurate and up to date data could be found to have been imprudent or not to have satisfied the adequate consideration requirement.

Recently, the Seventh Circuit has re-confirmed the view taken in *Cunningham* that fiduciaries who hire experts to value closely-held stock are entitled to rely on the expert's opinion, without any requirement that they themselves become experts who must undertake a critique of the valuator's methodology; provided only that the facts relied upon by the valuator are accurate and up to date.

In *Eyler v. Comm'r*, 88 F.3d 445 (7th Cir. 1996), Eyler, the majority owner of a closely-held company, sold $10 million worth of stock to the corporation's ESOP at a $14.50 per share price, which was based on a price range that Pru-Bache had determined as the underwriter for an initial public offering of the company. After the attempted offering failed due to the lack of interest by potential investors in the stock at $14.50 per share, the company sold the stock to the ESOP at that price.

Affirming a ruling of the tax court that the $14.50 per share price paid by the ESOP was in excess of adequate consideration, the Seventh Circuit emphasized that "the adequate consideration test focuses on the conduct of the fiduciaries in determining the price, not the price itself." *Id.* at 455.

In applying this standard, the basis of the court's decision that the adequate consideration standard had not been met was that the board failed to correct faulty

factual assumptions upon which the valuation was based. The court found that the board, acting as fiduciary, had arrived at a price relying only on a financial consultant, who had prepared no valuation report, and the Pru-Bache letter, which, as the court noted, "was nearly four months old and prepared for an IPO that was subsequently shelved." *Id.* at 455. The court noted further that:

> the Pru-Bache valuation was based on underlying assumptions that significantly changed by the time of the board meeting. The major assumptions included the absence of an ESOP and its accompanying contributions and loan guarantee, and the influx of millions of dollars of cash as a result of the IPO. . . . The record is devoid of any evidence that the board gave proper consideration to the effect of any of these intervening factors.

Id. at 455.

As shown above, Department of Labor regulations and cases uniformly encourage fiduciaries to hire and rely on experts for the purpose of valuing the stock of closely-held companies. The ruling of the Ninth Circuit clearly conflicts with both the Fifth and Seventh Circuits and, if allowed to stand, fundamentally changes the duties of a fiduciary seeking to fulfill its responsibilities under ERISA to properly value closely-held stock.

Whereas before the Ninth Circuit's ruling a fiduciary was required only to prudently select a qualified independent valuator, permit that valuator to function independently of any inappropriate pressures or influences and ensure that the factual basis for the valuator's decision was complete, accurate and up to date; now according to the Ninth Circuit, the fiduciary must substitute its own opinion for the opinion of the expert on the value of the shares. If any "uncertainties" exist, then the fiduciary is required to hire a second expert.

Nowhere in the Ninth Circuit's decision is there an explanation as to how this new rule would operate. To protect itself from allegations of fiduciary breach, the individual fiduciary would essentially have to hire at least two valuators in every case, and each valuator would have to base its valuation opinion on the facts, without regard to the methodology used by the other valuator. Not only does this double the cost that the employer must devote to experts, nowhere in ERISA is there a hint of such a requirement. Because the employer ordinarily bears the cost of establishing any employer stock based employee benefit plan and also funding it, the Ninth Circuit's ruling, even for the brave employer who attempts to follow it, will cause the employer to have less money available to contribute to such a plan as benefits for employees.

Furthermore, and perhaps more importantly, it is unclear what the fiduciary should do if, as will certainly almost always be the case, the two experts do not agree on the value of the closely-held shares. As noted in *Cunningham*, "Appraisal of closely held stock is a very inexact science." *Id.* at 1473. At this point is the employer required to hire a *third* valuator to see which is more nearly correct? Or is the employer required to average the difference in value arrived at by the original two valuators? These questions remain unanswered and, as a practical matter, put fiduciaries who act on behalf of plans holding company stock at severe risk for performing tasks that are clearly permitted under ERISA and that, prior to the Ninth Circuit's ruling, were duties that the fiduciary could take practical, prudent and clearly identifiable steps to meet.

The rule enunciated by the Ninth Circuit, however, makes it perilous indeed for a fiduciary who decides to act on behalf of a plan purchasing or selling company stock, for the fiduciary itself must now essentially be a

valuation expert in order to comply with the Ninth Circuit's requirement that it adequately critique the report prepared by the professional valuator. It simply does not make sense to encourage fiduciaries on the one hand to hire and rely on independent appraisers to value company stock, and then to penalize them, as the Ninth Circuit has done, for doing just that.

As stated in *Cunningham*:

> On the one hand, Congress has repeatedly expressed its intent to encourage the formation of ESOPs by passing legislation granting such plans favorable treatment, and has warned against judicial and administrative action that would thwart that goal. Competing with Congress' expressed policy to foster the formation of ESOPs is the policy expressed in equally forceful terms in ERISA: that of safeguarding the interests of participants in employee benefit plans by vigorously enforcing standards of fiduciary responsibility. . . .
>
> Our task in interpreting the statute is to balance these concerns so that competent fiduciaries will not be afraid to serve, but without giving unscrupulous ones a license to steal. More, though we are guided by principles of trust law, we must bear in mind that in ERISA Congress departed from the absolute common law rule against fiduciaries' dual loyalties. ERISA clearly provides that a fiduciary may be an officer or employee of the company whose securities he purchases on behalf of a plan. Thus the stringent prophylactic rules of the common law cannot be incorporated reflexively under the statute.

Id. at 1466-67 (footnotes and citations omitted).

II. Under ERISA, Whether Adequate Consideration Has Been Received By A Plan In Its Sale Of Company Stock Does Not Vary Depending On Whom The Buyer Is.

In its decision, the Ninth Circuit holds that a prudent fiduciary would have questioned the application of a minority discount to the stock sold by the ESOP to the party in interest, even where the ESOP's interest unquestionably represented a minority interest in the company. What the court believed was inappropriate was the application of a minority discount to the stock holdings of a stock-based benefit plan where the party in interest, as purchaser, already had control of the company *before* making its purchase from the plan:

> Second, Arthur Young applied a minority interest discount . . . and it assumed that Shay was entitled to the full benefit of this discount even though, once purchased, the ESOP's minority block would merge with his controlling block and he would capture all of the increased value. A prudent fidicuary would have questioned these assumptions.

Howard v. Shay, 100 F.3d 1484, 1489 (9th Cir. 1996).

Practical applications of the Ninth Circuit's view on this issue lead to absurd results. For example, assume that on one day an employer stock based plan sold equal amounts of stock to two buyers, one a majority stockholder of the company and the second a new buyer. Under the Ninth Circuit's rationale the fiduciary of the plan would be imprudent unless it obtained a premium from the majority stockholder but would not be committing a breach to sell the very same stock on the same day to the new buyer without obtaining such a premium.

While there is ample support for the idea that the sale of control of a company should command a premium, there is no basis in prior case law, the Proposed Regulations or logic for a rule that when literally applied

would result in a higher price being obtained by the plan for the same stock depending on what the buyer's existing stockholdings are. Whatever value can be attributed to control of the company was *already owned* by the party in interest *before* it purchased stock in the ESOP. Since the party in interest already *had* control of the company, the additional stock it bought from the ESOP did not add to or detract from that control. Thus, it makes little sense to require the ESOP to extract extra money from the party in interest based on control of the company, when that is something the party in interest already owns, and something the ESOP is not selling.

To take the example one step further, after paying a control premium for a minority block of stock on day one, suppose that the majority shareholder sells some of that stock back to the plan the next day. After purchasing the stock for a control premium on one day, can the majority shareholder then sell the very same stock back to the plan for the same price on the very next day? Not under the Ninth Circuit's ruling, unless the plan is a majority shareholder. Of course, the stock's value did not change between day one and day two, and yet the Ninth Circuit's holding would seem to require the parties to ignore this obvious economic reality.

As discussed above, a sale of stock by a party in interest to an employer stock based employee benefit plan, or vice-versa, is exempt from the prohibited transaction rule of ERISA Section 406 (29 U.S.C. § 1106) if the sale of stock is for "adequate consideration." In the context of close corporations, there is often no reliable history of actual sales and therefore, the valuation of stock is difficult. The DOL's Proposed Regulations defining "adequate consideration" provide that:

> "fair market value" . . . means the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter

> is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well informed about the asset and the market for such an asset.

53 Fed. Reg. 17,637 (to be codified at 29 C.F.R. § 2510.3-18(b)(2)) (Proposed May 17, 1988).

Thus, in accordance with business reality, the adequate consideration requirement for purposes of ERISA has uniformly been interpreted to mean fair market value, defined as the price at which property would change hands between a *hypothetical* willing buyer and a *hypothetical* willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. *See, e.g., Eyler v. Comm'r,* 88 F.3d 445, 451 (7th Cir. 1996) (The requirement of fair market value "has been interpreted repeatedly by the IRS and the courts as requiring that the willing buyer and seller be *hypothetical.*") (emphasis added); *Reich v. Valley National Bank of Arizona,* 837 F. Supp. 1259 (S.D.N.Y. 1993) (holding that purchase of stock by ESOP was for more than adequate consideration where fiduciary did not refer to a *hypothetical* buyer, but rather, analyzed the investment in terms of the same conditions paid by the ESOP); *Capital City Excavating Co. v. Comm'r,* 47 T.C.M. 1527, 1530 (1984) (In the context of closely-held corporations, "shares must be valued on the basis of what willing buyers and willing sellers would be likely to pay or to accept in *hypothetical* sales.") (emphasis added).

In its decision, the Ninth Circuit has totally failed to follow the well-established *hypothetical* willing buyer and seller approach and instead has invented a new requirement for the application of minority discounts in sales between plans and parties in interest that is contrary to logic and to virtually every other case that has ruled in this area. This, of course, creates a major conflict with these other circuits. The Ninth Circuit's decision also illustrates the inadvisability of requiring fiduciaries to

question the methodology of a valuation expert. What may at first seem obvious to a non-expert can easily, upon further analysis, turn out to be dead wrong. Fiduciaries who make such mistakes in questioning an expert's valuation opinion may conclude in light of the Ninth Circuit's decision that to fulfill their fiduciary duties they must disregard the opinion of the expert, and end up like the Ninth Circuit has by making a grievous error in valuation that reliance on the expert would have prevented.

CONCLUSION

For all the reasons set forth above, Amicus Curiae Crowley Maritime Corporation urges the Court to grant certiorari in this case, and to overturn the erroneous holdings of the Ninth Circuit Court of Appeals.

Dated: April 29, 1997

Respectfully submitted,

CAMERON W. WOLFE, JR.
Counsel of Record

PAUL C. BORDEN
ORRICK, HERRINGTON
& SUTCLIFFE LLP

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No. 96-1580

IN THE
Supreme Court of the United States
OCTOBER TERM, 1996

EDWARD A. SHAY, *et al.*,
Petitioners,

v.

NEWMAN HOWARD, *et al.*,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF OF *AMICUS CURIAE* AMERICAN ACADEMY OF ACTUARIES IN SUPPORT OF PETITIONERS

LAUREN M. BLOOM
AMERICAN ACADEMY OF ACTUARIES
1100 Seventeenth Street, N.W.
Washington, D.C. 20036
(202) 223-8196
Counsel of Record for the American Academy of Actuaries

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MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE*

The American Academy of Actuaries (the "Academy") hereby moves the Court for leave to submit this brief as *amicus curiae*, pursuant to Rule 37 of the Rules of the Supreme Court of the United States, in support of the petition for certiorari in No. 96-1580. The petitioners have consented to the filing of this brief, as is demonstrated by the accompanying letter of consent from petitioners' counsel. Respondents have refused consent.

The Academy is a nonprofit professional association of approximately 13,000 actuaries of all specialties (health, life, pension and property-casualty) practicing in the United States. Many of the Academy's member actuaries work closely with plan fiduciaries to provide professional services to ERISA plans. The appellate court's analysis in

this case has the potential to significantly limit fiduciaries' ability to rely upon the expert advice they receive from actuaries and other service providers, undercutting the value of the expert services that actuaries provide to ERISA plans. Such a result could be severely harmful to practicing pension actuaries and, therefore, the Academy has a substantial interest in that aspect of this case.

Additionally, many of the Academy's members practice as expert witnesses, providing actuarial testimony to courts, administrative bodies, and legislators. The appellate court's rejection of the valuation techniques used in this case was apparently based upon its own independent evaluation of those techniques, and not upon expert testimony offered at trial. Unless this aspect of the appellate court's decision is addressed by the Court, a precedent will be established that any appellate court may, on its own initiative, independently declare expert testimony and techniques invalid. Such a result would inevitably devalue expert testimony, bringing severe injury to the Academy's members who practice as expert witnesses. The Academy, therefore, has a substantial interest in this aspect of the case as well.

The Academy is, moreover, well positioned to advise the Court on the potential consequences of the appellate court's decision for actuaries and others who provide professional services to ERISA plans and expert testimony in judicial, legislative, and regulatory proceedings. Although the petition for certiorari and respondents' opposition to the petition dealt at some length with the particulars of the appellate court's decision and its effect upon the individual parties to the case, we do not believe that the broader implications of the appellate court's decision have yet been fully addressed. The Academy respectfully requests the opportunity to share with the Court its concerns regarding the potential impact of this case on ERISA service providers and expert witnesses.

The Academy's brief is short, and addresses only those aspects of the case that are of importance to our members and within the scope of our expertise. Further, we observe that respondents have lodged two *amicus curiae* briefs in support of their own position while refusing consent to the filing of this or (we understand) any other *amicus curiae* brief in support of the petition for certiorari. If the Court is going to have the benefit of the views expressed in those briefs, we believe that the Court should also have access to the information that can be provided by the Academy in support of the petition for certiorari.

For the foregoing reasons, we respectfully request that this motion for leave to file the Academy's *amicus curiae* brief be granted.

Respectfully submitted,

LAUREN M. BLOOM
AMERICAN ACADEMY OF ACTUARIES
1100 Seventeenth Street, N.W.
Washington, D.C. 20036
(202) 223-8196
Counsel of Record for the
American Academy of Actuaries

May 7, 1997

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1996

No. 96-1580

EDWARD A. SHAY, *et al.*,
Petitioners,

v.

NEWMAN HOWARD, *et al.*,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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BRIEF OF *AMICUS CURIAE* AMERICAN ACADEMY OF ACTUARIES IN SUPPORT OF PETITIONERS

The American Academy of Actuaries submits this brief as *amicus curiae*, pursuant to Rule 37 of the Rules of the Supreme Court of the United States, in support of the petition for certiorari in No. 96-1580.

STATEMENT OF INTEREST OF *AMICUS CURIAE*

The American Academy of Actuaries (the "Academy") is a nonprofit professional association established in 1965 to provide a common membership organization for actuaries of all specialties (health, life, pension and property-casualty) practicing in the United States. To become an Academy member, an actuary must satisfy rigorous edu-

cation and experience requirements. Membership in the Academy is a prerequisite in many states for actuaries to be eligible to perform certain statutorily-required professional services. The Academy's membership is approximately 13,000 actuaries nationwide.

The Academy regularly provides unbiased expertise to state legislatures, regulators, and Congress on the actuarial implications of laws and regulations involving insurance, health care and retirement income security.[1] The Academy also participates as an *amicus curiae* in court cases with significant actuarial implications. For example, in 1995 the Academy joined with the American Society of Pension Actuaries in submitting an *amicus curiae* brief in support of the petitioners in *Lockheed Corporation v. Spink*, —— U.S. ——, 116 S. Ct. 1783 (1996) ("*Lockheed*"). Similarly, in 1992, the Academy submitted an *amicus curiae* brief in support of the respondents in *Mertens v. Hewitt Associates*, 508 U.S. 248 (1993) ("*Mertens*").

As we previously advised the Court in *Lockheed* and *Mertens*, the Academy's many members who provide professional services to ERISA plans "work closely with plan fiduciaries," and are significantly affected by the Court's rulings on the relationship and respective liabilities between fiduciaries and the non-fiduciary experts who provide professional services to ERISA plans. The appellate court's analysis here has the potential severely to limit fiduciaries' ability to rely upon the expert advice they receive from actuaries and other service providers. If left unaddressed, the appellate court's reasoning may undercut

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[1] For example, the Academy recently testified on Capitol Hill concerning development of a network of private insurance to supplement Medicare. "Provider Network Bill Sponsors Seek Middle Ground on Solvency, Regulation," *BNA's Daily Report for Executives* (March 20, 1997). The Academy also recently participated in a forum on Social Security reform sponsored by Senator Ben Campbell of Colorado. "Panelists Say No Easy Social Security Solutions," *Northern Wyoming Daily News* (March 26, 1997).

the value of the expert services that Academy members provide to ERISA plans.

Further, many of the Academy's members practice as expert witnesses, providing actuarial testimony to courts, administrative bodies, and legislators.[2] The appellate court's rejection of the valuation techniques used in this case was apparently based upon its own independent evaluation of those techniques, and not upon other expert testimony offered. Moreover, the appellate court did not rule that the trial court's findings of fact were "clearly erroneous," a fundamental requirement if an appellate court reverses a trial court's factual findings. Unless this aspect of the appellate court's decision is overturned by the Court, a precedent will be established that any appellate court may, on its own initiative, independently declare expert testimony and techniques invalid. Such a result would substantially devalue expert testimony, bringing severe injury to the Academy's members who practice as expert witness.

For these reasons, the Academy has a substantial interest in this case.

SUMMARY OF ARGUMENT

The appellate court's decision in this case does not merely require ERISA fiduciaries who engage in self-dealing transactions to retain the services of outside experts, provide those experts with all relevant, material information, and refrain from providing any false or misleading information. The appellate court also requires the fiduciary to "question" the expert's conclusion and, in

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[2] Indeed, so many of the Academy's members practice as expert witnesses that the Actuarial Standards Board, a committee created by the Academy's bylaws to promulgate standards of practice for actuaries practicing in the United States, has seen fit to issue Actuarial Standard of Practice No. 17, "Expert Tetimony." This standard offers guidance to actuaries who practice as expert witnesses.

some unspecified circumstances, to "retain a second firm to review it." This requirement goes beyond the scope of fiduciaries' responsibilities as described by other federal appellate courts, and essentially calls for the fiduciary to become almost as expert as the professional from whom the fiduciary seeks advice. Fiduciaries who seek to satisfy the appellate court's requirements are likely to feel decreasingly able to rely on the opinions and recommendations of their expert service providers, and may well feel increasingly obliged to retain a second opinion whenever the fiduciary believes that an outside party could find some reason to question the expert's conclusions. Such a trend could result in the devaluation of expert services to ERISA plans, and increase the costs of administration of those plans, to the ultimate detriment of the plan participants.

Further, the appellate court rejected the techniques and assumptions used by the valuation expert in this case without either finding that the appellate court's factual conclusions were clearly erroneous or relying upon other expert testimony provided below. It appears that the appellate court simply determined on its own that the valuation was unsatisfactory, a determination that exceeded the scope of the court's appellate review function. Unless this aspect of the appellate court's decision is reversed, a precedent will be set permitting an appellate court summarily to reject expert testimony on its own initiative. Such a precedent would significantly decrease the value of expert testimony, and could cause substantial harm to the judicial process.

ARGUMENT

I. THE APPELLATE COURT'S DECISION MAY PREVENT FIDUCIARIES FROM RELYING IN GOOD FAITH UPON THE ADVICE OF EXPERTS WHO PROVIDE PROFESSIONAL SERVICES TO ERISA PLANS.

The Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1101 *et seq.* ("ERISA"), prohibits the fiduciaries of an employee stock ownership plan ("ESOP") from engaging in self-dealing transactions with the plan. 29 U.S.C. § 1106. ERISA also contains an exception to this prohibition for the purchase or sale by a plan of qualifying employer securities if, among other things, the transaction is for "adequate consideration." 29 U.S.C. § 1108(e). It is the statutory requirement for adequate consideration that is at issue in this case.

The fiduciaries for an ESOP operated by the Pacific Architects and Engineers, Inc. ("PAE") agreed to sell PAE stock owned by the ESOP to a trust created by Edward A. Shay, a plan fiduciary. The fiduciaries hired Arthur Young & Company ("Arthur Young") to perform a valuation of the stock, and sold the stock at the price determined by Arthur Young to be fair market value.[3] The plan participants and beneficiaries sued the fiduciaries, arguing that they had breached their ERISA obligations by selling the stock for less than adequate consideration.

After a six-week bench trial, the district court found that the ESOP fiduciaries had acted appropriately in selecting Arthur Young, had provided Arthur Young with all the relevant, material information required to properly conduct the valuation, and did not provide any false or misleading information. The district court did not find that the fiduciaries had any knowledge to con-

[3] The Academy takes no position concerning the appropriateness of the valuation methods used by Arthur Young in this case.

tradict or reason to question Arthur Young's valuation. The district court also found that the price set by Arthur Young constituted "full, fair, and adequate consideration" for the stock, and that the fiduciaries had not, therefore, breached their duties under ERISA.

The appellate court disagreed, finding that the ESOP fiduciaries had not acted with sufficient prudence. Criticizing Arthur Young's valuation, the court concluded that the fiduciaries should have determined that reliance on Arthur Young's valuation was not "reasonable under the circumstances." The appellate court further stated that the fiduciaries should have "question[ed] the valuation or retain[ed] a second firm to review it." *Howard v. Shay*, 100 F.3d 1484, 1489 (9th Cir. 1996). The court then declined to uphold the trial court's ruling that the fiduciaries had fulfilled their ERISA duties. *Id.* at 1490.

The appellate court's decision is inconsistent with the leading First Circuit case that addresses this issue, *Donovan v. Cunningham*, 715 F.2d 1455 (5th Cir. 1983). In *Cunningham*, the court specifically held that ERISA fiduciaries "need not become experts in the valuation of closely-held stock," but need only provide complete and up-to-date information to an expert and cease to rely upon that expert's opinion when the fiduciary knows the opinion is based on obsolete information. *Id.* at 1474 (citations omitted).[4]

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[4] The Seventh Circuit Court of Appeals set forth a similar analysis in *Eyler v. Commissioner of Internal Revenue*, 88 F.3d 445 (7th Cir. 1996). In *Eyler*, the court found that plan fiduciaries could not meet their ERISA obligations solely by relying on their attorney's representation that a self-dealing transaction met the requirements of ERISA, but observed that "there is no evidence that the law firm performed a valuation analysis or that the firm purported to possess particular expertise in valuing stock." *Id.* at 456. Thus, *Eyler* suggests that, had the fiduciaries relied upon a current valuation analysis from a qualified expert, their ERISA obligations might well have been satisfied.

As the dissent below observed, "the majority cites [*Cunningham*] to support the creation of a new and unwarranted requirement for ERISA fiduciaries who would obtain expert opinions—that fiduciaries must make certain that reliance on an expert's advice is reasonably justified under the circumstances. *Cunningham* simply does not stand for that proposition." *Howard,* 100 F.3d at 1490. The Academy agrees that the appellate court's additional requirement is unwarranted. As the courts have observed, the valuation of closely-held stock is a difficult task for which "the opinions of experts are peculiarly appropriate." *Central Trust Company v. United States,* 305 F.2d 393, 399 (U.S. Ct. of Claims 1962), *citing Bader v. United States,* 172 F. Supp. 83 (D.C. S.D. Ill. 1959). Requiring ERISA fiduciaries to recognize when they may rely upon an expert's advice and when they must question that advice or seek a second opinion can force the fiduciary to possess or acquire tremendous expertise. This requirement is inconsistent with Congress' intent in ERISA "not to create a system that is so complex that administrative costs, or litigation expenses, unduly discourage employers from offering welfare benefit plans in the first place." *Varity Corporation v. Howe,* —— U.S. ——, 116 S. Ct. 1065, 1070 (1996). It may also be inconsistent with the skills of many fiduciaries.

In our experience, fiduciaries vary widely in their understanding of valuation techniques. Less sophisticated fiduciaries must rely on actuaries and other experts properly to value plan assets and liabilities. Those fiduciaries are unlikely to be able to comply easily with the appellate court's new requirements, and may fear substantial personal liability if they fail to obtain a second opinion on every piece of expert advice they receive. Such an outcome would increase plan's administrative costs, and would make it more difficult for actuaries and other professional service providers to work with fiduciaries in an atmosphere of mutual confidence.

As the appellate court observed, "a fiduciary who is determined to self deal has ample opportunity to sway the final valuation that will set the transaction price . . . either in selecting of the expert or by limiting the information conveyed to the expert." *Howard,* 100 F.3d at 1490. Where, as the trial court found here, the fiduciary properly selects the expert and conveys to the expert all relevant, material information, the fiduciary should be permitted to rely in good faith on the expert's opinion unless the fiduciary knows or has reason to know that opinion to be flawed. We urge the Court to grant certiorari to rectify this aspect of the decision below.

II. THE APPELLATE COURT ERRED IN INDEPENDENTLY REJECTING ARTHUR YOUNG'S EXPERT TESTIMONY.

Much of the appellate court's decision focuses on perceived flaws in the valuation techniques and assumptions used by Arthur Young to value the PAE ESOP stock. Indeed, the appellate court found the valuation to be so manifestly flawed that "[e]ven a cursory review of the Arthur Young valuation and fairness opinion reveals the carelessness" of the fiduciaries' reliance. *Howard,* 100 F.3d at 1489. The appellate court, however, never cited any expert authority to support its criticisms of the Arthur Young valuation. Moreover, the appellate court never found the trial court's holdings, that the discounts applied by Arthur Young were appropriate and that the valuation presented a fair picture to the ESOP fiduciaries, to be "clearly erroneous."

As this Court has long recognized, it is the role of the trial court, as finder of fact, "[to] draw inferences, to weigh the evidence, and to declare the result." *Helvering v. National Grocery Co.,* 304 U.S. 282, 294, *reh'g denied,* 305 U.S. 669 (1938). A court of appeals may reject a trial court's findings "only if those findings are clearly erroneous." *Citibank, N.A. v. Wells Fargo Asia*

Ltd., 495 U.S. 660, 670 (1990).[5] Fair market value of a stock is a question of fact reviewable under the "clearly erroneous" standard. *Eyler,* 88 F.3d at 451.

Here, the trial court conducted a six-week inquiry into the facts underlying the Arthur Young valuation. After weighing the evidence, the trial court found that the discounts applied by Arthur Young were "appropriate, were not improper or excessive, and were adequately justified by Arthur Young and Company and by the expert testimony offered by Defendants." *Howard v. Shay,* No. CV 91-146DT, slip op. at ¶ 29 (C.D. Cal. Filed Oct. 3, 1993). The trial court also found that the Arthur Young valuation report and fairness opinion "presented a fair evaluation of the transaction in question to the plan fiduciaries." *Id.* at ¶ 33.

The appellate court manifestly disagreed with the trial court's evaluation of the factual evidence. However, absent a specific finding that the trial court's holdings were "clearly erroneous," the appellate court had no basis to reject the trial court's factual findings. In this respect, the appellate court's decision inappropriately usurped the fact finding role of the trial court.

Perhaps more critically, the appellate court failed to cite any other expert authority for its criticisms of the Arthur Young valuation. Although both parties presented expert testimony at trial, the appellate court did not refer to expert testimony submitted by the plan participants, nor did it address the particulars of the expert testimony offered by the ESOP fiduciaries. Instead, the appellate court appears to have decided on its own that Arthur Young's selected discounts were excessive, and

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[5] Federal Rule of Civil Procedure 52(a) specifically provides:

> Findings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge the credibility of the witnesses.

that Arthur Young failed to provide adequate explanation for the assumptions and techniques it selected.

The valuation of stocks and other assets owned by ERISA plans is a complex process, requiring the expert selection and application of numerous assumptions. Appellate courts typically lack the expertise to determine independently whether appropriate techniques and assumptions underlie an expert valuation. The trial court's factual findings were based on expert evidence submitted at trial, and were not found by the appellate court to be clearly erroneous. If the appellate court's ruling is permitted to stand, it will set the precedent that an appellate court can summarily reject expert testimony that has been favorably evaluated by a trial court without reference to the underlying record or to other expert evidence. Such an outcome will reduce the value of expert testimony, and may disrupt the judicial system as trial courts attempt to determine what weight, if any, they are permitted to assign to expert testimony. We therefore urge the Court to grant certiorari, and to specifically overrule this aspect of the appellate court's decision.

CONCLUSION

For the foregoing reasons, the Academy respectfully requests that the Court grant certiorari to consider the aspects of the appellate court's decision that are addressed in this brief.

Respectfully submitted,

LAUREN M. BLOOM
AMERICAN ACADEMY OF ACTUARIES
1100 Seventeenth Street, N.W.
Washington, D.C. 20036
(202) 223-8196
Counsel of Record for the
American Academy of Actuaries

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